# THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED SRI LANKA BRANCH

## FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016

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# THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED SRI LANKA BRANCH

## FINANCIAL STATEMENTS

## FINANCIAL STATEMENTS
## 31 DECEMBER 2016

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED**
**SRI LANKA BRANCH**

**FOR THE YEAR ENDED 31 DECEMBER 2016**

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# Independent auditor's report

## To the head office management of Hongkong and Shanghai Banking Corporation Limited Sri Lanka Branch

## Report on the financial statements

We have audited the accompanying financial statements of Hongkong and Shanghai Banking Corporation Limited - Sri Lanka Branch ("the Branch) which comprise the statement of financial position as at 31 December 2016, and the income statement, statement of other comprehensive income, statement of changes in equity and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information as set out in pages 7 to 65.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation of financial statements that give a true and fair view in accordance with Sri Lanka Accounting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Sri Lanka Auditing Standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

### *Opinion*

In our opinion, the financial statements of the Hongkong and Shanghai Banking Corporation Limited -Sri Lanka Branch give a true and fair view of the financial positions of the Branch as at 31 December 2016, and of their financial performance and cash flows for the year then ended, in accordance with Sri Lanka Accounting Standards.

30 March 2017
**COLOMBO**

PricewaterhouseCoopers
**CHARTERED ACCOUNTANTS**

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THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH

## INCOME STATEMENT

### FOR THE YEAR ENDED 31 DECEMBER

| | Note | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|---|
| Interest income | | **25,738,799** | 23,548,828 |
| Interest expenses | | **(8,446,028)** | (7,217,254) |
| **Net interest income** | 5 | **17,292,771** | 16,331,574 |
| Fee and commission income | | **3,484,406** | 3,781,024 |
| Fee and commission expenses | | **(632,242)** | (661,297) |
| **Net fee and commission income** | 6 | **2,852,164** | 3,119,727 |
| Net gain from trading | 7 | **2,145,086** | 1,509,156 |
| Net (loss) / gain from financial investments | 8 | **(5,910)** | 705,274 |
| Other operating income (net) | 9 | **49,675** | 61,065 |
| **Total operating income** | | **22,333,786** | 21,726,796 |
| Impairment (charge) / reversal for loans and other losses | 10 | **(201,978)** | 620,603 |
| **Net operating income** | | **22,131,808** | 22,347,399 |
| Personnel expenses | 11 | **(3,247,346)** | (3,431,337) |
| Other expenses | 12 | **(6,558,175)** | (6,181,330) |
| **Operating profit before Value Added Tax** | | **12,326,287** | 12,734,732 |
| Value Added Tax on financial services | | **(1,689,578)** | (1,535,048) |
| **Profit before tax** | | **10,636,709** | 11,199,684 |
| Income tax expense | 13 | **(4,025,792)** | (3,676,034) |
| **Profit for the year** | | **6,610,917** | 7,523,650 |

Figures in brackets indicate deductions.

The financial statements are to be read in conjunction with the related notes as set out on pages 7 to 65 which form a part of the financial statements of the Branch. The Report of the Auditors is given on page 1.

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Colombo

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH

## STATEMENT OF OTHER COMPREHENSIVE INCOME

### FOR THE YEAR ENDED 31 DECEMBER

| | Note | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|---|
| **Profit for the year** | | **6,610,917** | 7,523,650 |
| **Other comprehensive income / (expenses)** | | | |
| **Items that may be reclassified to profit or loss** | | | |
| Loss on re-measuring available-for-sale financial assets | | **(696,655)** | (5,224,000) |
| Gain from the financial statements of foreign currency operation | | **962,728** | 1,739,423 |
| Tax relating to components of other comprehensive income | **13.d** | **197,149** | 1,454,386 |
| | | **463,222** | **(2,030,191)** |
| **Items that may not be reclassified to profit or loss** | | | |
| Actuarial (loss) / gain on defined benefit plans | | **(60,294)** | 363,329 |
| Gain on revaluation of property plant and equipment | | **197,641** | 89,050 |
| Tax relating to components of other comprehensive income | **13.d** | **(27,245)** | **175,785** |
| **Other comprehensive income for the year** | | **110,102** | **628,164** |
| **Total comprehensive income for the year** | | **7,184,241** | **6,121,623** |

Figures in brackets indicate deductions.

The financial statements are to be read in conjunction with the related notes as set out on pages 7 to 65 which form a part of the financial statements of the Branch. The Report of the Auditors is given on page 1.

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Colombo

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH

## STATEMENT OF FINANCIAL POSITION

### AS AT 31 DECEMBER

| | Note | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|---|
| **ASSETS** | | | |
| Cash and cash equivalents | 15 | **7,388,309** | 5,813,230 |
| Balances with the Central Bank of Sri Lanka | 16 | **9,090,026** | 6,724,825 |
| Placements with banks | 17 | **40,524,300** | 19,469,700 |
| Derivative financial instruments | 18 | **471,757** | 2,078,082 |
| Other financial assets held-for-trading | 19 | **756,106** | 330,826 |
| Loans and receivables from banks | 20 | **-** | 15,784,400 |
| Loans and receivables from other customers | 21 | **212,875,084** | 184,328,632 |
| Financial investments – available-for-sale | 22 | **122,514,575** | 131,828,703 |
| Property, plant and equipment | 23 | **3,737,377** | 3,644,899 |
| Deferred tax asset | 24 | **545,073** | 360,117 |
| Other assets | 25 | **13,400,066** | 16,316,284 |
| **Total assets** | | **411,302,673** | 386,679,698 |
| **LIABILITIES** | | | |
| Due to banks | 26 | **151,585,134** | 129,362,756 |
| Derivative financial instruments | 27 | **383,472** | 1,814,183 |
| Due to other customers | 28 | **183,343,212** | 182,887,530 |
| Current tax liabilities | | **1,720,293** | 1,548,753 |
| Other liabilities | 29 | **20,027,040** | 22,071,366 |
| **Total liabilities** | | **357,059,151** | 337,684,588 |
| **EQUITY** | | | |
| Assigned capital | 30 | **3,152,358** | 3,152,358 |
| Statutory reserve fund | 31 | **2,222,693** | 2,090,475 |
| Other reserves | 32 | **11,392,723** | 10,788,010 |
| Retained earnings | | **37,475,748** | 32,964,267 |
| **Total equity** | | **54,243,522** | 48,995,110 |
| **Total equity and liabilities** | | **411,302,673** | 386,679,698 |
| **Contingent liabilities and commitments** | 35 | **540,191,605** | **616,100,548** |

The financial statements are to be read in conjunction with the related notes as set out on pages 7 to 65 which form a part of the financial statements of the Branch. The Report of the Auditors is given on page 1.

The Management is responsible for the preparation and presentation of these Financial Statements. The Financial Statements have been prepared in compliance with Sri Lanka Financial Reporting Standards and the requirements of the Central Bank of Sri Lanka regulations and guidelines.

Approved and signed for and on behalf of the Management.

Patrick J Gallagher
(Signed) Chief Executive Officer

Kanchana Hewavitharana
(Signed) Chief Financial Officer

30th March 2017
Colombo

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH

## STATEMENT OF CHANGES IN EQUITY

| FOR THE YEAR ENDED 31 DECEMBER 2016 | Assigned Capital Rs.'000 | Exchange Equalisation of Capital Rs.'000 | Exchange Equalisation of Reserves Rs.'000 | IFA Reserve Rs.'000 | AFS Reserve Rs.'000 | SBP Reserve Rs.'000 | Statutory Reserve Fund Rs.'000 | Revaluation Reserve Rs.'000 | Retained Earnings Rs.'000 | Total Equity Rs.'000 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Balance as at 1 January 2015** | 3,152,358 | - | 2,300,185 | 5,108,459 | 3,280,148 | 159,402 | 1,940,002 | 1,781,682 | 30,452,554 | 48,174,790 |
| **Total comprehensive income for the year** | | | | | | | | | | |
| Profit for the year | - | - | - | - | - | - | - | - | 7,523,650 | 7,523,650 |
| Super gain tax paid as per part III of the finance act | - | - | - | - | - | - | - | - | (3,764,383) | (3,764,383) |
| **Other comprehensive income (net of tax)** | - | - | 1,739,423 | - | (3,769,614) | - | - | 206,431 | 421,733 | (1,402,027) |
| Total comprehensive income for the year | - | - | 1,739,423 | - | (3,769,614) | - | - | 206,431 | 4,181,000 | 2,357,240 |
| **Transactions with equity holders, recognised directly in equity** | | | | | | | | | | |
| Transfers to reserves during the year | - | - | - | - | - | 12,796 | 150,473 | - | (156,889) | 6,380 |
| Depreciation on revaluation reserve | | | | | | | | (30,902) | 30,902 | - |
| Profit transferred to head office | - | - | - | - | - | - | - | - | (1,543,300) | (1,543,300) |
| **Total transactions with equity holders** | - | - | - | - | - | 12,796 | 150,473 | (30,902) | (1,669,287) | (1,536,920) |
| **Balance as at 31 December 2015** | **3,152,358** | - | **4,039,608** | **5,108,459** | **(489,466)** | **172,198** | **2,090,475** | **1,957,211** | **32,964,267** | **48,995,110** |
| **Balance as at 1 January 2016** | **3,152,358** | - | **4,039,608** | **5,108,459** | **(489,466)** | **172,198** | **2,090,475** | **1,957,211** | **32,964,267** | **48,995,110** |
| **Total comprehensive income for the year** | | | | | | | | | | |
| Profit for the year | - | - | - | - | - | - | - | - | **6,610,917** | **6,610,917** |
| **Other comprehensive income (net of tax)** | - | - | **962,728** | - | **(499,505)** | - | - | **163,623** | **(53,522)** | **573,324** |
| Total comprehensive income for the year | - | - | **962,728** | - | **(499,505)** | - | - | **163,623** | **6,557,395** | **7,184,241** |
| **Transactions with equity holders, recognised directly in equity** | | | | | | | | | | |
| Transfers to reserves during the year | - | - | - | - | - | **(829)** | **132,218** | - | **(132,218)** | **(829)** |
| Deferred tax on revaluation reserve | - | - | - | - | - | - | - | **8,262** | **(8,262)** | - |
| Depreciation on revaluation reserve | | | | | | | | **(29,566)** | **29,566** | - |
| Profit transferred to head office | - | - | - | - | - | - | - | - | **(1,935,000)** | **(1,935,000)** |
| **Total transactions with equity holders** | - | - | - | - | - | **(829)** | **132,218** | **(21,304)** | **(2,045,914)** | **(1,935,829)** |
| **Balance as at 31 December 2016** | **3,152,358** | - | **5,002,336** | **5,108,459** | **(988,971)** | **171,369** | **2,222,693** | **2,099,530** | **37,475,748** | **54,243,522** |

Figures in brackets indicate deductions.

The financial statements are to be read in conjunction with the related notes as set out on pages 7 to 65 which form a part of the financial statements of the Branch. The Report of the Auditors is given on page 1.

PricewaterhouseCoopers Colombo

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH

## CASH FLOW STATEMENT

| FOR THE YEAR ENDED 31 DECEMBER | 2016<br>Rs.'000 | 2015<br>Rs.'000 |
|---|---|---|
| **Cash flow from Operating activities** | | |
| Interest received | **24,209,937** | 24,378,459 |
| Interest paid | **(6,166,626)** | (5,833,182) |
| Recoveries on previously written off loans | **204,908** | 622,847 |
| Fees and commission received | **2,852,164** | 3,119,727 |
| Dividends received | - | - |
| Net receipts from trading activities | **2,154,880** | 1,509,156 |
| Net receipts from investing activities | **(5,910)** | 705,274 |
| Operating expenses paid | **(9,233,463)** | (8,960,048) |
| **Operating profit before changes in operating assets and liabilities** | **14,015,890** | 15,542,233 |
| **Changes in operating assets and liabilities** | | |
| Decrease / (increase) in treasury bills and other eligible bills | **39,231,598** | 18,835,968 |
| Decrease in treasury bonds | **(27,815,617)** | 3,684,981 |
| Decrease / (increase) in loans to other banks | **(5,270,200)** | 6,511,288 |
| Increase in loans and advances | **(27,419,151)** | (16,597,499) |
| Increase in government bonds | **(3,224,974)** | (14,137,912) |
| (Increase) / decrease in other assets | **802,764** | (727,782) |
| Increase in deposits from customers | **455,682** | 6,540,770 |
| (Decrease) / increase in borrowings | **22,222,378** | (19,838,059) |
| Decrease in other liabilities | **(1,692,248)** | (1,449,675) |
| **Cash (used in) / from operating activities** | **(2,709,768)** | (17,177,920) |
| Income tax paid | **(6,171,416)** | (8,988,007) |
| **Net cash flows (used in) / generated from operating activities** | **5,134,707** | (10,623,694) |
| **Cash flow from investing activities** | | |
| Proceeds from disposal of property, plant and equipment | **16,877** | 17,747 |
| Acquisition of property, plant and equipment | **(239,411)** | (1,044,317) |
| **Net cash flow used in investing activities** | **(222,534)** | (1,026,570) |
| **Cash flow from financing activities** | | |
| Profit transferred to Head Office | **(1,935,000)** | (1,543,300) |
| **Net cash flow used in financing activities** | **(1,935,000)** | (1,543,300) |
| **Net (decrease) / increase in cash and cash equivalents** | **2,977,173** | (13,193,563) |
| **Cash and cash equivalents at the beginning of period** | **12,538,055** | 24,015,548 |
| **Exchange adjustment** | **963,107** | 1,716,070 |
| **Cash and cash equivalents at the end of the year [Note A]** | **16,478,335** | 12,538,055 |
| **Note A** | | |
| **Analysis of cash and cash equivalents at the end of the year** | | |
| Cash in hand and balances with banks | **1,184,525** | 1,016,228 |
| Balances with other banks | **6,203,784** | 4,797,002 |
| Balances with Central Bank | **9,090,026** | 6,724,825 |
| | **16,478,335** | 12,538,055 |

Figures in brackets indicate deductions.

The financial statements are to be read in conjunction with the related notes as set out on pages 7 to 65 which form a part of the financial statements of the Branch. The Report of the Auditors is given on page 1.

PricewaterhouseCoopers
Colombo

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

### 1 Corporate information

#### 1.1 Domicile and legal form

The HongKong and Shanghai Banking Corporation Limited is a public limited liability company incorporated in Hongkong SAR. It carries out banking activities in Sri Lanka through HSBC Sri Lanka Branch ("the Branch"), a licensed commercial bank registered under the Banking Act No 30 of 1988 as amended by the Banking Amendment Act No 33 of 1995. The registered office of HSBC Sri Lanka Branch is located at No. 24, Sir Baron Jayatilaka Mawatha, Colombo 1.

#### 1.2 Principal activities and nature of operations

The principal activities of the Branch, which is carrying out banking activities through its branches remained unchanged during the year. The primary banking services include corporate and retail banking including credit cards and global trade finance. The Branch terminated its primary dealer business in 2016 which was used to deal in Government and Central Bank of Sri Lanka securities through the primary auctions.

#### 1.3 Parent company and ultimate parent company

The immediate parent entity is the HongKong and Shanghai Banking Corporation Limited and the ultimate parent entity is HSBC Holding plc (incorporated in Great Britain and registered in England and Wales). The ultimate parent is listed on the Hong Kong and London stock exchanges.

### 2 Basis of preparation

#### 2.1 Statement of compliance

The financial statements of the Branch which comprise the statement of financial position, income statement, statement of changes in equity, statement of cash flows and notes thereto have been prepared in accordance with relevant Sri Lanka Accounting Standards (SLFRSs and LKASs) laid down by the Institute of Chartered Accountants of Sri Lanka and comply with the requirements of the Banking Act No. 30 of 1988 and subsequent amendments thereto.

#### 2.2 Basis of measurement

The financial statements have been prepared on the historical cost basis and applied consistently with no adjustments being made for inflationary factors affecting the financial statements, except for the following;

- Assets and liabilities held for trading are measured at fair value
- Derivative financial instruments are measured at fair value
- Available for sale financial assets are measured at fair value
- Liability for defined benefit obligations is recognized as the present value of the defined benefit obligation.
- Certain freehold land and buildings that are measured at fair value

#### 2.3 Functional and presentation currency

The financial statements are presented in Sri Lankan Rupees, which is the Branch's presentation and functional currency. The items in the financial statements are measured using the currency of the primary economic environment in which the Branch operates (the functional currency).

## 2 Basis of preparation (contd)

### 2.4 Use of Estimates and Judgment

The preparation of financial statements require management to make judgment estimates and assumptions that effects the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period of which the estimate is revised and in any future period affected. The significant estimates and judgements are disclosed in Note 4.

### 2.5 Changes in accounting standards

**(a) New accounting standards, amendments and interpretations adopted in 2016**

The following amendments to the Sri Lanka Accounting Standards that are relevant for the preparation of the Branch's financial statements have been adopted by the Branch for the first time with effect from financial year beginning on 1 January 2016.

(i) LKAS 16, 'Property, plant and equipment' and LKAS 38, 'Intangible Assets', clarify that a revenue-based method of depreciation is generally not appropriate.

(ii) LKAS 38 'Intangible Assets now includes a rebuttable presumption that the amortisation of intangible assets based on revenue is inappropriate. This presumption can be overcome if either

- The intangible asset is expressed as a measure of revenue (i.e where a measure of revenue is the limiting factor on the value that can be derived from the asset), or
- It can be shown that revenue and the consumption of economic benefits generated by the asset are highly correlated.

(iii) SLFRS 7, 'Financial Instruments: Disclosures', provide specific guidance for transferred financial assets to help management to determine whether the terms of a servicing arrangement constitute 'continuing involvement' and, therefore, whether the asset qualifies for derecognition. It further clarifies that the additional disclosures relating to the offsetting of financial assets and financial liabilities only need to be included in interim reports if required by LKAS 34 'Interim Financial Reporting'.

(iv) LKAS 19, 'Employee Benefits', clarify that when determining the discount rate for post-employment benefit obligations, it is the currency that the liabilities are denominated in that is important and not the country where they arise.

(v) LKAS 1, 'Presentation of Financial Statements', amendments is made in the context of the IASB's Disclosure Initiative, which explores how financial statement disclosures can be improved. LKAS 1 provide clarifications on a number of issues, including: materiality, disaggregation and subtotals, notes to the financial statements and OCI arising from investments accounted for under the equity method. According to the transitional provisions, the disclosures in LKAS 8 regarding the adoption of new standards/accounting policies are not required for these amendments.

## 2 Basis of preparation (contd)

### 2.5 Changes in accounting standards (contd)

**(b) New accounting standards, amendments and interpretations issued but not yet adopted**
The following new standards and amendments to standards had been issued but were not mandatory for annual reporting periods ending 31 December 2016.

(i) Amendments to LKAS 7 'Statement of Cash Flows – Disclosure Initiative' introduce an additional disclosure on changes in liabilities arising from financing activities. The amendments to the standard are effective for accounting periods beginning on or after 1 January 2017.

(ii) Amendments to SLFRS 2 'Share Based Payments– clarifies the treatment of vesting and non-vesting conditions and accounting for a modification of a share -based payment transaction that changes its classification from cash -settled to equity –settled. The amendments to the standard are effective for accounting periods beginning on or after 1 January 2018. Earlier application is permitted.

(iii) Amendments to LKAS 12 'Income Taxes - Recognition of Deferred Tax Assets for Unrealised Losses' (effective from 1 January 2017) clarify the requirements for recognising deferred tax assets on unrealised losses arising from deductible temporary difference on asset carried at fair value. In addition, in evaluating whether an entity will have sufficient taxable profits in future periods against which deductible temporary differences can be utilised, the amendments require an entity to compare the deductible temporary differences with future taxable profits that excludes tax deductions resulting from the reversal of those temporary differences. The amendments to the standard are effective for accounting periods beginning on or after 1 January 2017.

(iv) SLFRS 9 'Financial Instruments',retains but simplifies the mixed measurement model in LKAS 39 'Financial Instruments: Recognition and Measurement' and establishes a single model that has only three primary classification categories for financial assets: amortised cost, fair value through profit or loss and fair value through Other Comprehensive Income ("OCI") for certain financial assets that are debt instruments.

Classification of debt assets will be driven by the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets.A debt instrument is measured at amortised cost only if the entity is holding it to collect contractual cash flows and the cash flows represent principal and interest. All other debt and equity instruments, including investments in complex debt instruments and equity investments, must be recognised at fair value. All fair value movements on financial assets are taken through the profit or loss, except for equity investments that are not held for trading, which may be recorded in the profit or loss or in reserves without subsequent recycling to the profit or loss.

For financial liabilities, the standard retains most of the LKAS 39 requirements. These include amortised cost accounting for most financial liabilities, with bifurcation of embedded derivatives. The main change is that, in cases where the fair value option is taken for financial liabilities, the part of a fair value change due to an entity's own credit risk is recorded in OCI rather than the profit or loss, unless this creates an accounting mismatch.

**2 Basis of preparation (contd)**

**2.5 Changes in accounting standards (contd)**

**(b) New accounting standards, amendments and interpretations issued but not yet adopted (contd)**

The new hedge accounting rules align hedge accounting more closely with common risk management practices. As a general rule, it will be easier to apply hedge accounting going forward. Further, SLFRS 9 introduces a new expected credit losses model on impairment for all financial assets that replaces the incurred loss impairment model used in LKAS 39. The expected credit losses model is forward-looking and eliminates the need for a trigger event to have occurred before credit losses are recognised.

SLFRS 9 also introduces expanded disclosure requirements and a change in presentation .The standard is effective for accounting periods beginning on or after 1 January 2018. Early adoption is permitted.

(v) SLFRS 15 'Revenue from contracts with customers' replaces LKAS 18 'Revenue' and LKAS 11 'Construction contracts' and related interpretations. The core principle in SLFRS 15 is that an entity recognises revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Revenue is recognised when a customer obtains control of goods or services, i.e. when the customer has the ability to direct the use of and obtain the benefits from the goods or services.

A new five-step process is applied before revenue can be recognised:
- Identify contracts with customers
- Identify the separate performance obligations
- Determine the transaction price of the contract;
- Allocate the transaction price to each of the separate performance obligations; and
- Recognise the revenue as each performance obligation is satisfied.

Key provisions of the new standard are as follows:

- Any bundled goods or services that are distinct must be separately recognised, and any discounts or rebates on the contract price must generally be allocated to the separate elements.
- If the consideration varies (such as for incentives, rebates, performance fees, royalties, success of an outcome etc), minimum amounts of revenue must be recognised if they are not at significant risk of reversal.
- The point at which revenue is able to be recognised may shift: some revenue which is currently recognised at a point in time at the end of a contract may have to be recognised over the contract term and vice versa.
- There are new specific rules on licenses, warranties, non-refundable upfront fees, and consignment arrangements, to name a few.
- As with any new standard, there are also increased disclosures.

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**2 Basis of preparation (contd)**

**2.5 Changes in accounting standards (contd)**

**(b) New accounting standards, amendments and interpretations issued but not yet adopted (contd)**

The standard is effective for accounting periods beginning on or after 1 January 2018. Entities will have a choice of full retrospective application, or prospective application with additional disclosures and earlier application is permitted.

(vi) SLFRS 16, 'Leases' supersedes LKAS 17 'Leases' and the related interpretations. Under SLFRS 16, a lease is a contract (or part of a contract) that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

SLFRS 16 eliminates the classification of leases by the lessee as either finance leases (on balance sheet) or operating leases (off balance sheet). SLFRS 16 requires a lessee to recognise a "right-of-use" of the underlying asset and a lease liability reflecting future lease payments for most leases. The right-of-use asset is depreciated in accordance with the principle in LKAS 16 'Property, Plant and Equipment' and the lease liability is accreted over time with interest expense recognised in the income statement.

For lessors, SLFRS 16 retains most of the requirements in LKAS 17. Lessors continue to classify all leases as either operating leases or finance leases and account for them differently.

The standard is effective for accounting periods beginning on or after 1 January 2019. Early adoption is permitted if SLFRS 15 'Revenue from Contracts with Customers' has also been applied.

The impact of SLFRS 9 'Financial Instruments', SLFRS 15 'Revenue from Contracts with Customers' and SLFRS 16 'Leases' are still being assessed. Apart from SLFRS 9, SLFRS 15 and SLFRS 16, the adoptions of amendments to published standards are not expected to have a material impact to the financial statements of the Branch.

There are no other standards or IFRIC interpretations that are not yet effective that would be expected to have a material impact to the Branch.

**2.6 Rounding of amounts**

All amounts disclosed in the financial statements and notes have been rounded off to the nearest thousand Sri Lankan Rupees unless otherwise stated.

## 3 Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these financial statements.

### 3.1 Foreign Currency Translation

Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies at year end exchange rates are generally recognised in income statement.

Foreign exchange gains and losses are presented in the income statement under net gains from trading with customers and others.

The results and financial position of foreign currency operation (Foreign Currency Banking Unit) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- assets and liabilities for each statement of financial position presented are translated at the closing rate at the date of that statement of financial position
- income and expenses for each statement of income statement and statement of comprehensive income are translated at spot exchange rates, and
- all resulting exchange differences are recognised in other comprehensive income.

Forward exchange contracts are valued at the forward market rates ruling on the reporting date. Both unrealised losses and gains are reflected in the income statement.

### 3.2 Interest

Interest income and expense is recognized in income statement using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate,a shorter period) to the carrying amount of the financial asset or liability. When calculating the effective interest rate, the Branch estimates future cash flows considering all contractual terms of the financial instrument, but not future credit losses.

When a receivable is impaired, the Branch reduces the carrying amount to its recoverable amount, being the estimated future cash flow discounted at the original effective interest rate of the instrument, and continues unwinding the discount as interest income. Interest income on impaired loans is recognised using the original effective interest rate.

The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or liability.

Interest income and expense presented in the income statement include;

- interest on financial assets and financial liabilities measured at amortized cost calculated on an effective interest basis;
- fair value changes in qualifying derivatives.

## 3 Significant accounting policies (contd)

### 3.3 Fees and commissions

The fees and commission income and expense that are integral to the effective interest rate on financial asset or liability are included in the measurement of the effective interest rate. Other fees and commissions are recognised in the period in which the services are rendered. The fees and commissions for services relating to periods after the reporting date is deferred in the statement of financial position.

Other fees and commission income, including account servicing fees, trade fees are recognized as the related services are performed.Other fees and commission expense relate mainly to transaction and service fees, which are expensed as the services are received.

### 3.4 Taxation

**Income taxation**

The provision for income tax is based on the element of the income and expenditure as reported in the Financial Statements and computed in accordance with the provisions of the Inland Revenue Act No.10 of 2006 and subsequent amendments thereto. The current income tax charge is calculated on the basis of the tax laws enacted or substantively enacted at end of the reporting period. Management periodically evaluate positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation. It established provisions where appropriate on the basis of amounts expected to be paid to the tax authorities.

Relevant details are disclosed in the Notes to the financial statements.

**Deferred tax**

Deferred tax is provided using the liability method on temporary differences at the reporting date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.Deferred tax assets and liabilities are recognised in full for all temporary differences. Deferred income tax is not accounted for 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 tax assets are recognised for all deductible temporary differences, carry-forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and the carry-forward of unused tax credits and unused tax losses can be utilized.The carrying amount of deferred tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilised.

Deferred income tax is determined using tax rates and laws that have been enacted or substantially enacted by the end of the reporting period and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Deferred tax assets and deferred tax liabilities are offset if a legally enforceable right exists to set off current tax assets against current tax liabilities and the deferred taxes relate to the same taxable entity and the same taxation authority.

Current and deferred tax is recognised in income statement, except to the extent that it relates to items recognised in other comprehensive income or directly in equity. In this case, the tax is also recognised in other comprehensive income or directly in equity, respectively.

## 3 Significant accounting policies (contd)

### 3.5 Financial assets and financial liabilities

### 3.5.1 Initial recognition and measurement

### 3.5.1.1 Investments and other financial assets

**Classification and reclassification**

The Branch classifies its financial assets in the following categories:

- Financial investments held for trading (at fair value through profit or loss)
- Loans and receivables,
- Financial investments available-for-sale.

The classification depends on the purpose for which the investments were acquired. Management determines the classification of its investments at initial recognition. There were no held to maturity financial assets at the reporting date.

The Branch may choose to reclassify a non-derivative trading financial asset out of the held for trading category if the financial asset is no longer held for the purpose of selling it in the near term. Financial assets other than loans and receivables are permitted to be reclassified out of the held for trading category only in rare circumstances arising from a single event that is unusual and highly unlikely to recur in the near term. In addition, the Branch may choose to reclassify financial assets that would meet the definition of loans and receivables out of the held for trading or available-for-sale categories if the Branch has the intention and ability to hold these financial assets for the foreseeable future or until maturity at the date of reclassification.

**Recognition**
Regular way purchases and sales of financial assets are recognised on trade-date, the date on which the Branch commits to purchase or sell the asset.

**Measurement**
At initial recognition, the Branch measures a financial asset at its fair value plus, in the case of a financial asset not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset. Transaction costs of financial assets carried at fair value through profit or loss are expensed in income statement.

Loans and receivables and held-to-maturity investments are subsequently carried at amortised cost using the effective interest method.

Available-for-sale financial assets and financial assets at fair value through profit or loss are subsequently carried at fair value. Gains or losses arising from changes in the fair value are recognised as follows:

- for 'financial assets at fair value through profit or loss' – in income statement within other income or other expenses.
- for available-for-sale financial assets that are monetary securities denominated in a foreign currency – translation differences related to changes in the amortised cost of the security are recognised in income statement and other changes in the carrying amount are recognised in other comprehensive income.
- for other monetary securities classified as available-for-sale – in other comprehensive income.

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**3 Significant accounting policies (contd)**

**3.5 Financial assets and financial liabilities (contd)**

**3.5.1 Initial recognition and measurement (contd)**

**3.5.1.1 Investments and other financial assets (contd)**

In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received).In certaincircumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the Branch recognises a trading gain or loss on inception of the financial instrument, being the difference between the transaction price and the fair value.

When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value from the transaction price as indicated by the valuation model is not recognised immediately in the income statement. Instead, it is recognised over the life of the transaction on an appropriate basis, when the inputs become observable, the transaction matures or is closed out, or when the Branch enters into an offsetting transaction.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are measured in accordance with HSBC's valuation methodologies.

**Financial investments - held for trading**

Financial assets at fair value through profit or loss include financial assets held for trading. Financial assets are classified as held for trading if they are acquired for the purpose of selling or repurchasing in the near term. This category includes derivative financial instruments entered into by the Branch that are not designated as hedging instruments in hedge relationships as defined by LKAS 39. Derivatives, including separated embedded derivatives are also classified as held for trading unless they are designated as effective hedging instruments. Financial assets at fair value through profit and loss are carried in the statement of financial position at fair value with changes in fair value recognized in finance income or finance costs in the income statement.

**Loans and advances**

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They mainly represent loans to customers, banks and others. After initial measurement, such financial assets are subsequently measured at amortized cost using the effective interest rate method (EIR), less impairment. Amortized cost is calculated by taking into account any discount or premium on acquisition and fees or costs that are an integral part of the EIR.

The EIR amortization is included in interest income in the income statement. The losses arising from impairment are recognized in the income statement in impairment charges for loans and other losses.

When the Branch purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date ("reverse repo"), the arrangement is accounted for as a loan or receivable, and the underlying asset is not recognized in the Branch's financial statements. The carrying value of the securities purchased under agreement to sell is recorded at cost. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest rate method.

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**3 Significant accounting policies (contd)**

**3.5 Financial assets and financial liabilities (contd)**

**3.5.1 Initial recognition and measurement (contd)**

**3.5.1.1 Investments and other financial assets (contd)**

**Available for sale financial investments**

Available-for-sale investments (AFS) are non-derivative investments that were designated as available-for-sale or are not classified as another category of financial assets.All available-for-sale investments are carried at fair value.

Interest income on AFS financial assets is recognized in income statement on straight line basis. However, the year to date gap between the straight line basis and the effective interest rate is monitored using a set threshold (currently, 2.5% of total year to date NII) and accounted for if the gap is material.

Other fair value changes are recognized in other comprehensive income until the investment is sold or impaired,whereupon the cumulative gains and losses previously recognized as in other comprehensive income are reclassified to income statement as a reclassification adjustment.

**3.5.1.2 Financial liabilities measured at amortised cost**

Financial liabilities not classified as fair value through profit or loss are classified as amortised cost instruments. Deposit liabilities including non interest bearing deposits, savings deposits,term deposits,deposits redeemable at call, certificates of deposit and borrowings are classified as financial liabilities measured at amortised cost.

**3.5.2 Derecognition**

**3.5.2.1 Financial assets**

Financial assets (or, where applicable a part of a financial asset or part of a group of similar financial assets) are derecognised when the rights to receive cash flows from the financial assets have expired or have been transferred and the Branch has transferred substantially all the risks and rewards of ownership. When securities classified as available-for-sale are sold, the accumulated fair value adjustments recognised in other comprehensive income are reclassified to income statement as gains and losses from investment securities.

The Branch has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a 'pass-through' arrangement; and either.

a) The Branch has transferred substantially all the risks and rewards of the asset,or

b) The Branch has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

## 3 Significant accounting policies (contd)

### 3.5 Financial assets and financial liabilities (contd)

### 3.5.2 Derecognition (contd)

#### 3.5.2.2 Financial liabilities

A financial liability is derecognized when the obligation under the liability is discharged or cancelled or expired. Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability. The difference between the carrying value of the original financial liability and the consideration paid is recognized in income statement.

When the Branch enters into an agreement to repurchase an asset (or a substantially similar asset) at a fixed price on a future date ("repo"), the counterparty liability is included as securities sold under repurchase agreements, as appropriate and the underlying asset will continued to be recognised in the Branch's financial statements. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreement using the effective interest method.

### 3.5.3 Offsetting

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Branch has a legal right to set off the recognized amounts and it intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted under SLFRSs, or for gains and losses arising from a group of similar transactions such as in the Branch's trading activity.

### 3.5.4 Amortized cost measurement

The amortized cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount recognized and the maturity amount, minus any reduction for impairment.

### 3.5.5 Fair value measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Branch measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, then the Branch establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses and option pricing models. The chosen valuation technique makes maximum use of market inputs, relies as little as possible on estimates specific to the Branch, incorporates all factors that market participants would consider in setting a price, and is consistent with accepted economic methodologies for pricing financial instruments. Inputs to valuation techniques reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument. The Branch calibrates valuation techniques and tests them for validity using pricesfrom observable current market transactions in the same instrument or based on other available observable market data.

**3 Significant accounting policies (contd)**

**3.5 Financial assets and financial liabilities (contd)**

**3.5.5 Fair value measurement (contd)**

Assets and long positions are measured at a bid price; liabilities and short positions are measured at an ask price. Where the Branch has positions with offsetting risks, mid-market prices are used to measure the offsetting risk positions and a bid or ask price adjustment is applied only to the net open position as appropriate. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Branch and the counterparty where appropriate.

**3.5.6 Impairment of financial assets**

The Branch assesses at each reporting date whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is deemed to be impaired if, and only if,there is objective evidence of impairment as a result of one or more events that has occurred after the initial recognition of the asset (an incurred 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated.

Evidence of impairment may include indications that the borrower or a group of borrowers is experiencing significant financial difficulty, the probability that they will enter bankruptcy or other financial reorganization, default or delinquency in interest or principal payments and where observable data indicates that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

**3.5.6.1 Impairment of financial assets carried at amortized cost**

For financial assets carried at amortized cost (such as loans and receivables from other HSBC branches, loans and receivables from customers as well as reverse repo investments), the Branch first assesses individually whether objective evidence of impairment exists for similar credit risk characteristics and collectively assesses them for impairment. If the Branch 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. Assets that are individually assessed for impairment and for which an impairment loss is, or continues to be recognized, are not included inthe collective assessment for impairment.If there is an objective evidence that an impairment loss 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 expected credit losses that have not yet been incurred). The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognized in the income statement. Interest income continues to be accrued on the reduced carrying amount and is accrued using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. The interest income is recorded as part of 'Interest and similar income'.

Loans together with the associated allowance are written off when there is no realistic prospect of future recovery and all collateral has been realized or has been transferred to the Branch. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognized, the previously recognized impairment loss is increased or reduced by adjusting the allowance account. If a future write–off is later recovered, the recovery is credited to the impairment charges for loans and other losses'.The present value of the estimated future cash flows is discounted at the financial asset's original effective interest rate. If a loan has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate. If the Branch has reclassified trading assets to loans and advances, the discount rate for measuring any impairment loss is the new effective interest rate determined at the reclassification date. The calculation of the present value of the estimated future cashflows of a collateralized financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

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## 3 Significant accounting policies (contd)

### 3.5 Financial assets and financial liabilities (contd)

### 3.5.6 Impairment of financial assets (contd)

#### 3.5.6.1 Impairment of financial assets carried at amortized cost (contd)

For the purpose of a collective evaluation of impairment, financial assets are grouped based on the nature and type of the asset. It also considers credit risk characteristics such as asset collateral type, past–due status and other relevant factors.Future cash flows on a group of financial assets that are collectively evaluated for impairment are estimated on the basis of 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 on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect, and are directionally consistent with, changes in related observable data from year to year (such as changes in unemployment rates, property prices, commodity prices, payment status, or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

#### 3.5.6.2 Available-for-sale financial investments

In the case of debt instruments classified as available–for–sale, the Branch assesses individually whether there is objective evidence of impairment based on thesame criteriaas financial assets carried at amortized cost. However, the amount recorded for impairment is the cumulative loss measured as the difference between the amortized cost and the current fair value, less any impairment loss on that investment previously recognized in the income statement. Future interest income is based on the reduced carrying amount and is accrued using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. The interest income is recorded as part of 'Interest and similar income'. If, in a subsequent period, the fair value of a debt instrument increases and the increase can be objectively related to a credit event occurring after the impairment loss was recognized in the income statement, the impairment loss is reversed through income statement.

### 3.5.7 Re-structured loans

Where possible, the Branch seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated any impairment is measured using the original effective interest rate as calculated before the modification of terms and the loan is no longer considered past due. Management continually reviews renegotiated loansto ensure that all criteria are met and that future payments are likely to occur. The loans continue to be subject to an individual or collective impairment assessment, calculated using the loan's original effective interest rate, unless there is a significant modification.

### 3.6 Events occurring after reporting date

All material events occurring after the reporting date are considered and disclosed and where necessary, adjustments are made in the financial statements.

## 3 Significant accounting policies (contd)

### 3.7 Cash flow statements

The Cash flow statment has been prepared and presented using the "Direct Method" of preparing cash flow statements in accordance with LKAS 7, Statements of Cash Flows.

Cash and cash equivalent comprise mainly of cash in hand, short-term placements with other Branches and highly liquid financial assets with original maturities of less than three months, which are subject to insignificant risk of changes in their fair value and are used by the Branch in the management of its short term commitments.

### 3.8 Comparative figures

The comparative figures and phrases have been re-arranged wherever necessary to conform to the current year's presentation. The accounting policies have been consistently applied by the Branch and are consistent with those of previous year.

### 3.9 Assets and bases of their valuation

### 3.9.1 Property, plant and equipment

**Initial measurement**

The property, plant and equipment are recorded at cost or revaluation. The cost of property, plant and equipment is the cost of purchase or construction together with any incidental expenses thereon and valuation is carried out once a year for land and building by an independent valuer. The property, plant and equipment are stated at cost or valuation (land, freehold buildings and improvements to buildings are carried at revalued amounts) less accumulated depreciation, which is provided for on the bases specified below and impairment losses. All property and equipment costing less than USD 400 and maintenance and repairs to equipment are charged to the income statement. All major renovations and renewals are capitalized.

**Depreciation**

The provision for depreciation is calculated on the cost or valuation of property, plant and equipment has been provided on straight line basis over the periods appropriate to estimated useful lives of the different types of property, plant and equipment as shown below. The Freehold land is not depreciated.

| Assets | No of Years |
|---|---|
| Freehold buildings and improvements to buildings | over 50 years |
| Fixed assets relating to head office refurbishment project | over 10 years/over 20 years |
| Office machinery | over 5 years |
| Furniture and equipment | over 5 years |
| ATM machines | over 7 years |
| Motor vehicles | over 4 years |
| Computer equipment including AS 400 system | over 5 years |
| Computer terminals | over 5 years |
| Local area networks (LAN) | over 4 years |

In addition to the above, refurbishments on office furniture and equipment carried out for lease hold properties will be depreciated based on the remaining lease term.

Depreciation is charged on monthly basis from the date of acquisition and no depreciation is charged on the month of disposal of the asset.

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## 3 Significant accounting policies (contd)

### 3.9 Assets and bases of their valuation (contd)

### 3.9.1 Property, plant and equipment (contd)

**Disposals**

Gain or loss on disposal of property, plant and equipment have been accounted for in the income statement by considering sales proceeds, cost and accumulated depreciation of such disposed item of property, plant and equipment.

**Impairment of assets**

An impairment loss is recognized if the carrying amount of an asset or its cash generating unit exceeds its recoverable amount. A cash generating unit is the smallest identifiable asset group that generates cash flows that are largely independent from other assets and groups. Impairment losses are recognized in income statement.

### 3.9.2 Bills negotiated and discounted

The bills are shown in the books at their face values. Bills in foreign currencies are converted at the year end exchange rates. The resulting gain or loss is dealt with in the income statement.

### 3.9.3 Cash and cash equivalents

Cash and short term funds are regarded as cash and cash equivalents as theseare funds held for the purpose of meeting short term cash commitments.Further, these funds have a short maturity of less than three months.

### 3.9.4 Statutory deposits with the Central Bank of Sri Lanka

The Monetary Law Act requires that all commercial banks operating in Sri Lanka to maintain a reserve against all deposit liabilities denominated in Sri Lankan Rupees. The reserve should be maintained for an amount equal to 7.5% of the total of such rupee deposit liabilities.

### 3.10 Employee share plans

Discretionary awards of shares granted under HSBC Group share plans align the interests of employees with those of shareholders. The Branch employee share plans are also aligned to group policy.

## 3 Significant accounting policies (contd)

### 3.10 Employee share plans (contd)

#### 3.10.1 Discretionary awards

In line with the HSBC Group share awards system, the Branch has entered into equity-settled share-based payment arrangements with its employees as compensation for services provided by employees. Equity-settled share-based payment arrangements entitle employees to receive equity instruments of HSBC Holdings plc.

The cost of equity-settled share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to 'Liability to HSBC Holdings'. The vesting period is the period during which all the specified vesting conditions of the arrangement are to be satisfied. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions of the award. Vesting conditions include service conditions and performance conditions; any other features of the arrangement are non-vesting conditions. Market performance conditions and non-vesting conditions are taken into account when estimating the fair value of the award at the date of grant, so that an award is treated as vesting irrespective of whether these conditions are satisfied, provided all other vesting conditions are satisfied.

### 3.11 Liabilities and provisions

#### 3.11.1 Employee retirement benefit obligation

**Pension fund**

All the employees of the Branch are eligible for the pension Fund. The Fund has been established under Trust Deed dated 7 December 1992 to fund the retirement benefits accruing to employees.

Up to 31 December 2008, the Branch operated the Pension Fund outside the financial statements of the Branch. Accordingly, no asset or liability was recognized in the financial statements of the Branch.

Up to 2012, the Pension Fund was a funded, non-contributory, defined benefit plan. In 2012, the Branch introduced an optional pension scheme which is defined contribution scheme. Therefore, currently the Branch operates two separate pension funds. Namely, the defined benefit plan and defined contributory plan.

The net of present value of defined benefit obligation, net of fair value of plan assets has been recognized in the statement of financial position.The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using a discount rate based on the interest rates of Government bonds that are denominated in the currency in which the benefits will be paid, and that have terms approximating to the terms of the related obligation. Current service cost, interest cost, expected return on plan assets are charged / credited to income statement and the actuarial gains / losses are recognised through other comprehensive income statement. Remeasurement gains and losses arising from experience adjustments and changes in actuarial assumptions are recognised in the period in which they occur, directly in other comprehensive income.

## 3 Significant accounting policies (contd)

### 3.11 Liabilities and provisions (contd)

#### 3.11.1 Employee retirement benefit obligation (contd)

**Pension fund (continued)**

The Branch carries out an actuarial valuation of the fund annually. The actuarial valuation is carried out by Towers Watson India Private Limited. The actuary has used the "Projected Unit Credit (PUC) Method" in determining the present value of defined benefit obligation and the contribution rate required to fund or provide for the promised benefits under the Pension fund.

In 2012, the Branch introduced an optional pension scheme which is a defined contribution scheme. Employees who opt for defined contribution scheme will be credited with an "opening balance" on the date of commencement of the new scheme, which is calculated taking factors such as service period, current pensionable salary, etc. The Branch contributes 10% of the gross salary thereon, on a monthly basis. The lump sum accrued (Branch's contribution plus interest) will be payable at the time of staff retirement or leaving service.

**Provident fund**

The Branch contributes to the approved Provident Fund, which is maintained outside the financial statements of the Branch. This is a defined contribution plan. The Branch contributes12% of the employees' gross salary to this fund whilst the employees contributes 8% of the gross salary. The Branch has no further payment obligations once the contributions have been paid.

**Trust fund**

The Branch contributes 3% of the gross salary of employees to the Employees Trust Fund (ETF), which is a defined contribution plan.The Branch has no further payment obligations once the contributions have been paid.

#### 3.11.2 Borrowings

Borrowings are initially recognised at fair value, net of transaction costs incurred. Borrowings are subsequently measured at amortised cost. Any difference between the proceeds (net of transaction costs) and the redemption amount is recognised in income statement over the period of the borrowings using the effective interest method. Borrowings are removed from the statement of financial position when the obligation specified in the contract is discharged, cancelled or expired.

#### 3.11.3 Other payables

These amounts represent liabilities for goods and services provided to the Branch prior to the end of financial year which are unpaid. The amounts are unsecured. Other payables are presented as other liabilities.

#### 3.11.4 Provisions

Provisions are recognised when the Branch has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation and the amount can be reliably estimated. Provisions are not recognised for future operating losses. Provisions are measured at the present value of management's best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

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## 3 Significant accounting policies (contd)

### 3.11 Liabilities and provisions (contd)

#### 3.11.5 Commitment and contingencies

All discernible risks are accounted for in determining the amount of other liabilities and all capital commitments and contingent liabilities are disclosed in the financial statements. Contingent liabilities are possible obligations whose existence will be confirmed only by uncertain future events or present obligations where the transfer of economic benefit is not probable or cannot reliably measured. To meet the financial needs of customers, the Branch enters into various irrevocable commitments and contingent liabilities. These consist of guarantees, letters of credit, and other undrawn commitments. These instruments commit the Branch to make payments on behalf of customers in the event of a specific act, generally related to import and export. They carry credit risk similar to loans and receivables. These contingent liabilities are disclosed in the financial statements as off balance sheet transactions.

#### 3.11.6 Other off-balance sheet transactions

The Branch enters into off- balance sheet transactions such as forward exchange contracts, currency swaps, interest rate swaps and options, the principle amounts of which are recorded as off balance sheet transactions. The financial derivatives in connection with these transactions are recorded in the trading position at fair value. The movement in fair value is recognized in the income statement.

### 3.12 Segment reporting

Segment information is presented for the identifiable operative business lines of the Branch and classified accordingly, which are the primary segments identified by the Branch.

## 4 Significant management estimates and judgements

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.

**Critical accounting estimates and assumptions**

The Branch makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results.Following are the mail financial statement line items that are subject accounting estimates and assumptions by management:

**Income and other taxes**

The Branch is subject to income tax and other tax such as Value Added Tax, Nation Building Tax and Crop Levy specifically levied on the banking and financial sector. The calculations are based on the provisions enacted as per the relevant Acts and guidelines published by Inland Revenue Department. The Branch recognises liabilities for any pending tax matters with the tax authorities based on estimates of whether additional taxes will be due. Where thefinal tax outcome of these matters is different from the amounts that were initiallyrecorded, such differences will impact the current and deferred income tax assetsand liabilities in the period in which such determination is made.

The recognition of a deferred tax asset relies on an assessment of the probability and sufficiency of future taxable profits, future reversals of existing taxable temporary differences and ongoing tax planning strategies.

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## 4 Significant management estimates and judgements (contd)

### Valuation of financial instruments

The best evidence of fair value is a quoted price in an actively traded principal market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. When a financial instrument has a quoted price in an active market, the fair value of the total holding of the financial instrument is calculated as the product of the number of units and the quoted price. The judgement as to whether a market is active may include, but is not restricted to, consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. Valuation techniques may incorporate assumptions about factors that other market participants would use in their valuations, including:

- the likelihood and expected timing of future cash flows on the instrument. Judgement may be required to assess the counterparty's ability to service the instrument in accordance with its contractual terms. Future cash flows may be sensitive to changes in market rates;

- selecting an appropriate discount rate for the instrument. Judgement is required to assess what a market participant would regard as the appropriate spread of the rate for an instrument over the appropriate risk-free rate; and

- Judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing derivative products.

A range of valuation techniques is employed, dependent on the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analyses, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to considering credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. 'Projection' utilises market forward curves, if available. In option models, the probability of different potential future outcomes must be considered. In addition, the value of some products is dependent on more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may affect the other market factors. The model inputs necessary to perform such calculations include interest rate yield curves, exchange rates, volatilities, correlations and prepayment and default rates. For interest rate derivatives with collateralised counterparties and in significant currencies, the Branch uses a discounting curve that reflects the overnight interest rate. The majority of valuation techniques employ only observable market data.

### Pension benefits

The present value of the pension obligations depends on a number of factors that are determined on an actuarial basis using a number of assumptions. The assumptions used in determining the net cost (income) for pensions include the discount rate. Any changes in these assumptions will impact the carrying amount of pension obligations. The Branch determines the appropriate discount rate at the end of each year. This is the interest rate that should be used to determine the present value of estimated future cash outflows expected to be required to settle the pension obligations. In determining the appropriate discount rate, the Branch considers the interest rates of Government bonds that are denominated in the currency in which the benefits will be paid and that have terms to maturity approximating the terms of the related pension obligation. Other key assumptions for pension obligations are based in part on current market conditions.

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## 4 Significant management estimates and judgements (contd)

### Impairment of loans and advances

Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the balance sheet date. Management is required to exercise judgement in making assumptions and estimates when calculating loan impairment allowances on both individually and collectively assessed loans and advances. Collective impairment allowances are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis due to the large number of individually insignificant loans in the portfolio. The estimation methods include the use of statistical analyses of historical information, supplemented with significant management judgement, to assess whether current economic and credit conditions are such that the actual level of incurred losses is likely to be greater or less than historical experience. Where changes in economic, regulatory or behavioural conditions result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models, risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographical concentrations, loan product features, economic conditions such as trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations and other influences on customer payment patterns.

The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

For individually assessed loans, judgement is required in determining whether there is objective evidence that a loss event has occurred and, if so, the measurement of the impairment allowance. In determining whether there is objective evidence that a loss event has occurred, judgement is exercised in evaluating all relevant information on indicators of impairment, including the consideration of whether payments are contractually past-due and the consideration of other factors indicating deterioration in the financial condition and outlook of borrowers affecting their ability to pay. A higher level of judgement is required for loans to borrowers showing signs of financial difficulty in market sectors experiencing economic stress, particularly where the likelihood of repayment is affected by the prospects for refinancing or the sale of a specified asset. For those loans where objective evidence of impairment exists, management determine the size of the allowance required based on a range of factors such as the realisable value of security, the likely dividend available on liquidation or bankruptcy, the viability of the customer's business model and the capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations.

The Branch might provide loan restructuring to borrowers experiencing financial difficulties by agreeing to modify the contractual payment terms of loans in order to improve the management of customer relationships, maximise collection opportunities or avoid default or repossession. Where restructuring activities are significant, higher levels of judgement and estimation uncertainty are involved in determining their effects on loan impairment allowances. Judgements are involved in differentiating the credit risk characteristics of restructured loans, including those which return to performing status following renegotiation.



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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31 DECEMBER

## 5 Net interest income

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| **Interest income** | | |
| Other financial assets held-for-trading (Note 5.1) | **262,311** | 149,772 |
| Loans and receivables to banks | **322,289** | 1,032,178 |
| Loans and receivables to other customers | **13,410,896** | 11,447,476 |
| Financial investments - available-for-sale (Note 5.1) | **11,642,617** | 10,896,288 |
| Others | **100,686** | 23,114 |
| **Total interest income** | **25,738,799** | 23,548,828 |
| **Interest expenses** | | |
| Due to banks | **(137,878)** | (155,741) |
| Due to other customers | **(6,893,158)** | (6,124,653) |
| Others | **(1,414,992)** | (936,860) |
| **Total interest expenses** | **(8,446,028)** | (7,217,254) |
| | **17,292,771** | 16,331,574 |

### 5.1 Net interest income from Sri Lanka Government Securities

| | | |
|---|---|---|
| Interest income | **11,904,928** | 11,046,060 |

## 6 Net fee and commission income

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Fee and commission income | **3,484,406** | 3,781,024 |
| Fee and commission expenses | **(632,242)** | (661,297) |
| | **2,852,164** | 3,119,727 |

### 6.1 Comprising

| | | |
|---|---|---|
| Loans | **82,487** | 202,081 |
| Credit cards | **1,590,622** | 1,997,775 |
| Trade and remittances | **1,043,045** | 1,093,299 |
| Deposits | **136,668** | 159,305 |
| Others | **(658)** | (332,733) |
| **Net fee and commission income** | **2,852,164** | 3,119,727 |

## 7 Net gain from trading

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Foreign exchange (excluding derivatives) | | |
| - Gain from transaction with customers | **2,410,057** | 1,696,638 |
| - Loss from transactions with others | **(365,637)** | (515,030) |
| Government securities | **178,254** | 143,769 |
| Derivatives | **(77,588)** | 183,779 |
| | **2,145,086** | 1,509,156 |

**8 Net gain from financial investments**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Net (loss) / gain from financial investments | **(5,910)** | 705,274 |
| | **(5,910)** | 705,274 |

**9 Other operating income (net)**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Profit on sale of property, plant and equipment | **16,879** | 17,747 |
| Others | **32,796** | 43,318 |
| | **49,675** | 61,065 |

**10 Impairment charges for loans and other losses**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Individual significant impairment (charge) / reversal (Note 10.1) | **(89,112)** | 181,606 |
| Collective impairment (charge) / reversal (Note 10.2) | **(112,866)** | 438,997 |
| | **(201,978)** | 620,603 |

**10.1 Individual significant impairment (charge) / reversal**

| | | |
|---|---|---|
| Impairment reversal /(provision) for the year | | |
| - For customer balances | **(124,234)** | 241,583 |
| Direct write-offs for the year | **(15,183)** | (80,208) |
| Recoveries during the year | **50,305** | 20,231 |
| | **(89,112)** | 181,606 |

**10.2 Collective impairment (charge) / reversal**

| | | |
|---|---|---|
| Impairment reversal / (provision) for the year | **249,045** | 833,228 |
| Direct write-offs for the year | **(634,814)** | (996,848) |
| Recoveries during the year | **272,904** | 602,617 |
| | **(112,865)** | 438,997 |

**11 Personnel expenses**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Salary and bonus | **(2,325,590)** | (2,331,758) |
| Others | **(921,756)** | (1,099,579) |
| | **(3,247,346)** | (3,431,337) |

## 14 Analysis of financial instruments on measurement basis

### 14.1 As at 31 December 2016

| | Held for Trading Rs.'000 | Amortized Cost Rs.'000 | Available for Sale Rs.'000 | Total Rs.'000 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Cash and cash equivalents | - | 7,388,309 | - | 7,388,309 |
| Balances with Central Bank | - | 9,090,026 | - | 9,090,026 |
| Placements with banks | - | 40,524,300 | - | 40,524,300 |
| Derivative financial instruments | 471,757 | - | - | 471,757 |
| Financial assets held for trading | 756,106 | - | - | 756,106 |
| Loans and receivables from banks | - | - | - | - |
| Loans and receivables from other customers | - | 212,875,084 | - | 212,875,084 |
| Financial investments | - | - | 122,514,575 | 122,514,575 |
| Acceptances and endorsements | - | 6,506,718 | - | 6,506,718 |
| **Total financial assets** | **1,227,863** | **276,384,437** | **122,514,575** | **400,126,875** |
| **LIABILITIES** | | | | |
| Due to banks | - | 151,585,134 | - | 151,585,134 |
| Derivative financial instruments | 383,472 | - | - | 383,472 |
| Due to other customers | - | 183,343,212 | - | 183,343,212 |
| Acceptances and endorsements | - | 6,506,718 | - | 6,506,718 |
| **Total financial liabilities** | **383,472** | **341,435,064** | **-** | **341,818,536** |

### 14.2 As At 31 December 2015

| | Held for Trading Rs.'000 | Amortized Cost Rs.'000 | Available for Sale Rs.'000 | Total Rs.'000 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Cash and cash equivalents | - | 5,813,230 | - | 5,813,230 |
| Balances with Central Bank | - | 6,724,825 | - | 6,724,825 |
| Placements with banks | - | 19,469,700 | - | 19,469,700 |
| Derivative financial instruments | 2,078,082 | - | - | 2,078,082 |
| Financial assets held for trading | 330,826 | - | - | 330,826 |
| Loans and receivables from banks | - | 15,784,400 | - | 15,784,400 |
| Loans and receivables from other customers | - | 184,328,632 | - | 184,328,632 |
| Financial investments | - | - | 131,828,703 | 131,828,703 |
| Acceptances and endorsements | - | 10,395,323 | - | 10,395,323 |
| **Total financial assets** | **2,408,908** | **242,516,110** | **131,828,703** | **376,753,721** |
| **LIABILITIES** | | | | |
| Due to banks | - | 129,362,756 | - | 129,362,756 |
| Derivative financial instruments | 1,814,183 | - | - | 1,814,183 |
| Due to other customers | - | 182,887,530 | - | 182,887,530 |
| Acceptances and endorsements | - | 10,395,323 | | 10,395,323 |
| **Total financial liabilities** | **1,814,183** | **322,645,609** | | **324,459,792** |

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31 DECEMBER

**12 Other expenses**

| | 2016<br>Rs.'000 | 2015<br>Rs.'000 |
|---|---|---|
| Auditors' remunerations | **(2,249)** | (3,037) |
| Non-audit fees to auditors | **(8,857)** | (1,202) |
| Professional and legal expenses | **(61,888)** | (55,146) |
| Depreciation of property, plant and equipment | **(337,479)** | (260,650) |
| Office administration and establishment expenses | **(2,215,743)** | (2,178,354) |
| Others | **(3,931,959)** | (3,682,941) |
| | **(6,558,175)** | (6,181,330) |

Main component of expenses classified as 'Others' is regionally allocated charges (RAC), which is remittable to regional Head Office.

**13 Tax expense**

| | 2016<br>Rs.'000 | 2015<br>Rs.'000 |
|---|---|---|
| **13.a Current tax expense** | | |
| Current tax on profit for the year (Note 13.c) | **(3,822,650)** | (3,499,656) |
| Over provision for the previous year | **(40,840)** | 198,005 |
| Tax of prior years paid in current year | **(13,095)** | - |
| Remittance tax | **(164,261)** | (169,394) |
| | **(4,040,846)** | (3,471,045) |
| **13.b Deferred tax expenses** | | |
| - Provision for employee benefit | **(3,012)** | 9,864 |
| - Allowance for loans losses | **(6,908)** | - |
| - Depreciation on revaluation of building | - | 5,556 |
| Deferred tax assets (recognized) / reversed during the year | **(9,920)** | 15,420 |
| - Allowance for loan losses | **16,712** | (214,410) |
| - Provision for employee benefit | - | (5,999) |
| - Depreciation on revaluation of land and building | **8,262** | - |
| Deferred tax liabilities recognized / (reversed) during the year | **24,974** | (220,409) |
| | **15,054** | (204,989) |
| **Total tax charge to income statement** | **(4,025,792)** | (3,676,034) |
| **13.c Reconciliation between tax expense and accounting profit** | | |
| Accounting profit before taxation | **10,636,709** | 11,199,685 |
| Add: disallowable items | **6,871,305** | 4,431,443 |
| Less: allowable items | **(1,989,832)** | (1,695,713) |
| Exempted income | **(1,865,860)** | (1,436,643) |
| | **13,652,322** | 12,498,772 |
| **Income tax @ 28%** | **(3,822,650)** | (3,499,656) |
| **13.d Tax charge to the statement of other comprehensive income** | | |
| -Provision for employee benefit | **6,772** | 58,405 |
| -AFS reserve | **197,149** | 1,454,386 |
| -Revaluation of buildings | **(34,017)** | 117,380 |
| | **169,904** | 1,630,171 |

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

AS AT 31 DECEMBER

## 15 Cash and cash equivalents

| | 2016<br>Rs.'000 | 2015<br>Rs.'000 |
|---|---|---|
| Cash in hand | 1,184,525 | 1,016,228 |
| Balances with other banks | 6,203,784 | 4,797,002 |
| | 7,388,309 | 5,813,230 |

## 16 Balances with the Central Bank of Sri Lanka

| | 2016<br>Rs.'000 | 2015<br>Rs.'000 |
|---|---|---|
| Balances with Central Bank | 9,090,026 | 6,724,825 |
| | 9,090,026 | 6,724,825 |

As required by the provisions of Section 93 of the Monetary Law Act, a cash balance is maintained with the Central Bank of Sri Lanka. The minimum cash reserve requirement on Rupee deposit liabilities was 7.5% as at 31st December 2016 ( 2015 : 6%).

## 17 Placements with banks

| | 2016<br>Rs.'000 | 2015<br>Rs.'000 |
|---|---|---|
| Placements | 40,524,300 | 19,469,700 |
| Others | 40,524,300 | 19,469,700 |

## 18 Derivative financial instruments

| | 2016<br>Rs.'000 | 2015<br>Rs.'000 |
|---|---|---|
| Interest rate derivatives | | |
| Interest rate swaps | 73,889 | 167,443 |
| Currency options | 162 | 102,096 |
| Forward foreign exchange contracts | 397,706 | 1,808,543 |
| | 471,757 | 2,078,082 |

## 19 Other financial assets held-for-trading

| | 2016<br>Rs.'000 | 2015<br>Rs.'000 |
|---|---|---|
| Treasury bills | - | 110,947 |
| Treasury bonds | 756,106 | 219,879 |
| | 756,106 | 330,826 |

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## 20 Loans and receivables from banks

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Gross loans and receivables (Note 20.1) | - | 15,784,400 |
| | - | 15,784,400 |

### 20.1 Analysis

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| **a.** By product | | |
| Short-term loans | - | 2,884,400 |
| Reverse repo agreements | - | 12,900,000 |
| **Gross total** | - | 15,784,400 |
| **b.** By currency | | |
| Sri Lankan Rupee | - | 12,900,000 |
| United States Dollar | - | 2,884,400 |
| **Gross Total** | - | 15,784,400 |

## 21 Loans and receivables from other customers

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Gross loans and receivables **(Note 21.1)** | **213,996,134** | 185,361,144 |
| Less: Provision for impairment loss **(Note 21.2)** | **(1,121,050)** | (1,032,512) |
| **Net loans and receivables** | **212,875,084** | 184,328,632 |

### 21.1 Analysis

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| **a. By product** | | |
| Overdrafts | **16,737,168** | 15,073,915 |
| Trade finance | **34,672,361** | 42,745,177 |
| Credit cards | **20,521,991** | 19,317,096 |
| Staff loans | **2,104,415** | 2,280,864 |
| Term loans - short term | **17,223,539** | 16,925,334 |
| Term loans - long term | **121,702,319** | 88,008,077 |
| Mortgages | **1,034,341** | 1,010,681 |
| **Gross total** | **213,996,134** | 185,361,144 |
| **b. By currency** | | |
| Sri Lankan Rupee | **64,246,656** | 65,336,192 |
| United States Dollar | **141,817,921** | 118,661,642 |
| Great Britain Pound | **411,211** | 524,535 |
| Others | **7,520,346** | 838,775 |
| **Gross total** | **213,996,134** | 185,361,144 |
| **c. By industry** | | |
| Agriculture and fishing | **8,947,102** | 4,289,665 |
| Manufacturing | **49,218,345** | 51,764,868 |
| Tourism | **29,036,938** | 16,941,550 |
| Transport | **14,636,098** | 13,523,675 |
| Construction | **5,102,524** | 4,327,920 |
| Traders | **29,182,741** | 27,278,362 |
| New economy | **19,071,795** | 14,208,398 |
| Others | **58,800,591** | 53,026,706 |
| **Gross total** | **213,996,134** | 185,361,144 |

## 21 Loans and receivables from other customers (contd)

### 21.2 Provision for impairment loss

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| **a. Individual impairment charges** | | |
| Opening balance | **698,755** | 950,637 |
| Charge for the year | **107,994** | (242,554) |
| Exchange fluctuations and other movements | **(79,141)** | (9,328) |
| Closing balance | **727,608** | 698,755 |
| **b. Collective impairment charges** | | |
| Opening balance | **333,757** | 1,228,250 |
| Charge for the year | **108,870** | (833,228) |
| Exchange fluctuations and other movements | **(49,185)** | (61,265) |
| Closing balance | **393,442** | 333,757 |
| **Total** | **1,121,050** | 1,032,512 |

## 22 Financial investments – available-for-sale

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Treasury bills | **6,162,641** | 45,248,956 |
| Treasury bonds | **116,351,934** | 86,579,747 |
| | **122,514,575** | 131,828,703 |

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**23 Property, plant and equipment**

| | Land | Freehold buildings and improvements | Office equipment, furniture and fittings | Household equipment, furniture and fittings | Office Machines | Computer hardware and software | Motor Vehicle | Capital Work in Progress | Total |
|---|---|---|---|---|---|---|---|---|---|
| | Rs.'000 | Rs.'000 | Rs.'000 | Rs.'000 | Rs.'000 | Rs.'000 | Rs.'000 | Rs.'000 | Rs.'000 |
| **Cost / revalued amount** | | | | | | | | | |
| Balance as at 1 January 2015 | 1,361,000 | 1,039,000 | 445,998 | 17,154 | 210,585 | 660,020 | 314,676 | 466,322 | 4,514,755 |
| Additions during the year | - | 525,716 | 425,500 | 162 | 15,040 | 77,618 | 281 | - | 1,044,318 |
| Disposals during the year | - | - | (114,719) | - | (39,400) | (157,513) | (46,122) | - | (357,754) |
| Transfers during the year | | (18,316) | 18,316 | - | - | - | - | (466,322) | (466,322) |
| Revaluation gain | 337,000 | (269,399) | - | - | - | - | - | - | 67,601 |
| **Balance as at 31 December 2015** | 1,698,000 | 1,277,001 | 775,095 | 17,316 | 186,225 | 580,125 | 268,835 | - | 4,802,597 |
| **Balance as at 1 January 2016** | **1,698,000** | **1,277,001** | **775,095** | **17,316** | **186,225** | **580,125** | **268,835** | **-** | **4,802,597** |
| **Additions during the year** | **-** | **80,630** | **71,472** | **931** | **1,517** | **65,961** | **18,900** | **-** | **239,412** |
| **Disposals during the year** | **-** | **(27,000)** | **(110,993)** | **(1,566)** | **(8,658)** | **(1,965)** | **(65,515)** | **-** | **(215,697)** |
| **Transfers during the year** | | **-** | **(313)** | | **(283)** | **596** | | **-** | **-** |
| **Revaluation gain** | **76,147** | **17,749** | **-** | **-** | **-** | **-** | **-** | **-** | **93,896** |
| **Balance as at 31 December 2016** | **1,774,147** | **1,348,380** | **735,261** | **16,681** | **178,801** | **644,717** | **222,220** | **-** | **4,920,207** |
| **Accumulated depreciation** | | | | | | | | | |
| Balance as at 1st January 2015 | - | - | 378,366 | 16,493 | 195,796 | 434,497 | 207,271 | - | 1,232,423 |
| Charge for the year | - | 22,106 | 113,112 | 435 | 5,929 | 76,530 | 42,539 | - | 260,651 |
| Disposals during the year | - | | (11,561) | - | (39,355) | (150,285) | (46,124) | - | (247,325) |
| Reclassified during the year | - | 72,628 | (65,970) | - | 82 | (57) | - | - | 6,683 |
| Revaluation adjustment | - | (94,734) | - | - | - | - | - | - | (94,734) |
| Balance as at 31 December 2015 | - | - | 413,947 | 16,928 | 162,452 | 360,685 | 203,686 | - | 1,157,698 |
| **Balance as at 1 January 2016** | **-** | **-** | **413,947** | **16,928** | **162,452** | **360,685** | **203,686** | **-** | **1,157,698** |
| **Charge for the year** | **-** | **128,290** | **78,486** | **223** | **7,572** | **82,999** | **39,838** | **-** | **337,408** |
| **Reclassified during the year** | **-** | **-** | **(28)** | **-** | **(27)** | **55** | **-** | **-** | **-** |
| **Revaluation adjustment** | **-** | **(128,295)** | | | | | | **-** | **(128,295)** |
| **Disposals during the year** | **-** | **5** | **(110,992)** | **(1,452)** | **(8,612)** | **(1,200)** | **(61,730)** | **-** | **(183,981)** |
| **Balance as at 31 December 2016** | **-** | **-** | **381,413** | **15,699** | **161,385** | **442,539** | **181,794** | **-** | **1,182,830** |
| **Carrying value** | | | | | | | | | |
| **As at 31 December 2015** | 1,698,000 | 1,277,001 | 361,148 | 388 | 23,773 | 219,440 | 65,149 | - | 3,644,899 |
| **As at 31 December 2016** | **1,774,147** | **1,348,380** | **353,848** | **982** | **17,416** | **202,178** | **40,426** | **-** | **3,737,377** |

a) As at 31 December 2016, property plant and equipment include fully depreciated assets of amounting to **Rs 786,274,406/-** which are still in use.

b) Carrying amounts that would have been recognised if land and buildings were stated at cost.

| | **Land** | | **Buildings** | |
|---|---|---|---|---|
| | **2016** | **2015** | **2016** | **2015** |
| | **Rs.** | **Rs.** | **Rs.** | **Rs.** |
| Cost | 4,970,000 | 4,970,000 | 1,092,427,363 | 1,014,952,970 |
| Accumulated depreciation | - | - | (193,970,991) | (95,182,122) |
| **Net book amount as at 31 December** | **4,970,000** | **4,970,000** | **898,456,372** | **919,770,848** |

## 23 Property, plant and equipment (Continued)

### 23.1 Methods and assumptions used in the fair valuation of property, plant and equipment

The Lands and buildings of the branch as at 31st December 2016 have been revalued and the revalued amounts have been incorporated in the financial statements for the year. This is considered as a level 2 valuation and the details of the valuation are given below.

| Property | Name and Qualifications of the valuer | Valuation Technique | Significant inputs used in the valuation | Inter-relationship between significant inputs and fair value measurement |
|---|---|---|---|---|
| Sir Baron Jayatilaka Mawatha, Colombo 01 | 1) Somy Thomas- MRICS, MBA(XLRI- Jamshedpur)<br>2)Anuradha Vijay-B.Arch, School of Urban planning, Delhi<br>3)Abhijith Ramasubramanian- ACA (Chartered Accountant) | Comparable market value method, income capitalisation method and depreciated replacement cost method have been used. | Per perch land price of comparable properties, per square foot rentals of comparable properties, capitalisation yield. | • Higher / (lower) the comparable property price / rental, higher / (lower) the property fair value.<br>• Higher / (lower) the capitalization yield, (lower) /higher the property fair value. |
| Independence Avenue, Colombo 07 | 1) Somy Thomas- MRICS, MBA(XLRI- Jamshedpur)<br>2)Anuradha Vijay-B.Arch, School of Urban planning, Delhi<br>3)Abhijith Ramasubramanian- ACA (Chartered Accountant) | Comparable market value method, income capitalisation method and depreciated replacement cost method have been used. | Per perch land price of comparable properties, per square foot rentals of comparable properties, capitalisation yield. | • Higher / (lower) the comparable property price / rental, higher / (lower) the property fair value.<br>• Higher / (lower) the capitalization yield, (lower) /higher the property fair value. |

If the capitalisation rate used in the property valuation was higher by 1%, the property values recognised in the statement of financial position would have been lower by Rs.105 mn and if the capitalisation rate used in the property valuation was lower by 1%, the property values recognised in the statement of financial position would have been higher by Rs.132 mn.

If the comparable market prices/rates used in the property valuation was higher by 10%, the property values recognised in the statement of financial position would have been higher by Rs,110 mn and if the capitalisation rate used in the property valuation was lower by 10%, the property values recognised in the statement of financial position would have been lower by Rs. 170 mn.



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## 24 Deferred tax assets / (liabilities)

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Deferred tax assets | **673,566** | 462,853 |
| Deferred tax liabilities | **(128,493)** | (102,736) |
| | **545,073** | 360,117 |

### 24.1 Reconciliation of deferred tax

Deferred tax assets and liabilities are attributable to the following:

| | 2016 | | 2015 | |
|---|---|---|---|---|
| | **Temporary Difference Rs. '000** | **Tax Effects Rs.'000** | Temporary Difference Rs.'000 | Tax Effects Rs.'000 |
| **Deferred tax assets on ;** | | | | |
| Accelerated depreciation for tax | | | | |
| - Property, plant and equipment | **28,299** | **7,924** | 52,970 | 14,832 |
| Provision for retirement benefit obligation | **599,933** | **167,981** | 586,505 | 164,221 |
| Allowance for loan losses | **393,443** | **110,164** | 333,757 | 93,452 |
| Available for sale reserve | **1,383,918** | **387,497** | 679,814 | 190,348 |
| | **2,405,593** | **673,566** | 1,653,046 | 462,853 |
| **Deferred tax liabilities on ;** | | | | |
| Revaluation of buildings | **(458,902)** | **(128,493)** | (366,914) | (102,736) |
| | **(458,902)** | **(128,493)** | (366,914) | (102,736) |
| **Net assets / (liabilities) as at 31 December** | **1,946,691** | **545,073** | 1,286,132 | 360,117 |

Deferred tax is computed using the effective tax rate of 28%.

## 25 Other assets

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Receivables | **3,560,334** | 4,028,970 |
| Deposits and prepayments | **538,116** | 501,350 |
| Acceptances and endorsements | **6,506,718** | 10,395,323 |
| Others | **2,794,898** | 1,390,641 |
| | **13,400,066** | 16,316,284 |

## 26 Due to banks

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Borrowings | **146,598,269** | 125,510,099 |
| Others | **4,986,865** | 3,852,657 |
| | **151,585,134** | 129,362,756 |

## 27 Derivative financial instruments

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Currency options | - | 8,283 |
| Interest rate derivatives | **74,713** | 177,078 |
| Forward foreign exchange contracts | **308,759** | 1,628,822 |
| | **383,472** | 1,814,183 |

| | | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|---|
| **28** | **Due to other customers** | | |
| | Total amount due to other customers (Note 28.1) | **183,343,212** | 182,887,530 |
| | | **183,343,212** | 182,887,530 |
| **28.1** | **Analysis** | | |
| | **a.** By product | | |
| | Demand deposits (current accounts) | **39,534,056** | 37,085,862 |
| | Savings deposits | **44,223,825** | 45,228,426 |
| | Fixed deposits | **95,583,529** | 95,873,451 |
| | Other deposits | **4,001,802** | 4,699,791 |
| | **Total** | **183,343,212** | 182,887,530 |
| | **b.** By currency | | |
| | Sri Lankan Rupees | **113,880,895** | 113,826,481 |
| | United State Dollar | **52,711,790** | 51,435,728 |
| | Great Britain Pound | **6,254,051** | 6,548,841 |
| | Others | **10,496,476** | 11,076,480 |
| | **Total** | **183,343,212** | 182,887,530 |

| | | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|---|
| **29** | **Other liabilities** | | |
| | Sundry creditors | **572,653** | 878,664 |
| | Interest payable | **7,749,764** | 5,630,724 |
| | Acceptances and endorsements | **6,506,718** | 10,395,323 |
| | Defined benefit liability -net **(Note 29.1)** | **(10,787)** | 19,138 |
| | Other payables | **5,208,692** | 5,147,517 |
| | | **20,027,040** | 22,071,366 |

| | | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|---|
| **29.1** | **Defined benefit liability - net** | | |
| | Present value of defined benefit obligations **(Note 29.1.a)** | **599,933** | 586,505 |
| | Fair value of plan assets **(Note 29.1.b)** | **(610,720)** | (567,367) |
| | | **(10,787)** | 19,138 |
| **29.1.a** | **Movement in the present value of defined benefit obligations** | | |
| | Opening balance | **586,505** | 934,107 |
| | Current service cost | **2,417** | 11,357 |
| | Interest cost | **72,746** | 84,070 |
| | Benefits paid during the year | **(85,919)** | (71,691) |
| | Actuarial gain for the year | **24,184** | (371,338) |
| | Closing balance | **599,933** | 586,505 |
| **29.1.b** | **Movement in fair value of plan assets** | | |
| | Opening balance | **567,367** | 534,689 |
| | Expected return on plan assets | **71,475** | 48,209 |
| | Contribution by employers | **84,000** | 74,000 |
| | Benefits paid during the year | **(85,919)** | (71,691) |
| | Actuarial loss for the year | **(26,203)** | (17,840) |
| | Closing balance | **610,720** | 567,367 |

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

AS AT 31 DECEMBER

**29 Other liabilities (contd)**

**29.1.c Sensitivity analysis of the defined benefit obligation - discount rate**

**a. Discount rate**

| | |
|---|---|
| **Discount rate as at 31 December 2016** | **13.30%** |
| 1. Effect due to the change in the discount rate to 14.30% (Rs '000) | (37,319) |
| 2. Effect due to the change in the discount to rate to 12.30% (Rs '000) | 42,833 |

**b. Salary escalation rate and post retirement pension increase**

| | | |
|---|---|---|
| **Increase as at 31 December 2016** | **Salary escalation rate** | |
| | **Union members** | **10%** |
| | **Non-union members** | **3%** |
| | **Post retirement pension** | **3.1%** |

**Salary escalation rate and post retirement pension**

| | |
|---|---|
| 1. Effect due to an increase in the salary escalation and post retirement pension rate by 1% p.a. (Rs '000) | 40,765 |
| 2. Effect due to a decrease in the salary escalation and post retirement pension rate by 1% p.a. (Rs '000) | (36,488) |

**30 Assigned capital**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Assigned capital | **3,152,358** | 3,152,358 |
| | **3,152,358** | 3,152,358 |

**31 Statutory reserve fund**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Opening balance | **2,090,475** | 1,940,002 |
| Transferred during the year | **132,218** | 150,473 |
| Closing balance | **2,222,693** | 2,090,475 |

The Statutory reserve fund is maintained as required by the section 20 (1) of the Banking Act No. 30 of 1988. The Bank appropriated 2% of the profit after tax to attain the minimum requirement under section 20(1) and the balance in the Statutory reserve fund will be used only for the purposes specified in the section 20(2) of the banking act No 30 of 1988.

**32 Other reserves**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Exchange equalisation of reserve (Note 32.1) | **5,002,336** | 4,039,608 |
| Available for sale reserve (Note 32.2) | **(988,971)** | (489,466) |
| Revaluation reserve (Note 32.3) | **2,099,530** | 1,957,211 |
| IFA reserve (Note 32.4) | **5,108,459** | 5,108,459 |
| SBP reserve (Note 32.5) | **171,369** | 172,198 |
| | **11,392,723** | 10,788,010 |

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## 32 Other reserves (continued)

### 32.1 Exchange equalisation of reserve

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Opening balance | **4,039,608** | 2,300,185 |
| Fluctuation of foreign exchange reserves | **962,728** | 1,739,423 |
| Closing balance | **5,002,336** | 4,039,608 |

### 32.2 Available for sale reserve

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Opening balance | **(489,466)** | 3,280,148 |
| Net loss on fair valuation | **(499,505)** | (3,769,614) |
| Closing balance | **(988,971)** | (489,466) |

### 32.3 Revaluation reserve

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Opening balance | **1,957,211** | 1,781,682 |
| Revaluation surplus for the year | **142,319** | 175,529 |
| Closing balance | **2,099,530** | 1,957,211 |

### 32.4 IFA reserve

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Opening balance | **5,108,459** | 5,108,459 |
| Transferred during the year | - | - |
| Closing balance | **5,108,459** | 5,108,459 |

According to the guidelines issued by the Central Bank of Sri Lanka, Banks are required to transfer 8% of the profit calculated for the payment of Value Added Tax (VAT) on financial services and 5% profit before tax calculated for payment of income tax to an Investment Fund Account. Operations of IFA ceased with effect from 01 October 2014 and the above indicates the balance accrued up to that date.

### 32.5 Share based payment reserve

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| Opening balance | **172,198** | 159,402 |
| Transferred during the year | **(829)** | 12,796 |
| Closing balance | **171,369** | 172,198 |

HSBC Sri Lanka had a share based payment scheme available for its employees, which provided share options to the employees. HSBC Holdings plc, registered in United Kingdom issued shares to the employees of HSBC Sri Lanka and the scheme does not contain any recharge arrangement to HSBC Holdings plc. Even though the share scheme ceased to be in existance, the value of shares granted by HSBC Holdings plc is accounted as a contribution from HSBC Holdings plc under equity of the Branch.

## 32 Other reserves (continued)

### 32.6 Share based payments and share option

#### 32.6.1 Restricted share awards - *No of Shares ('000)*

| | **2016** | 2015 |
|---|---|---|
| Outstanding at the beginning | **23,395** | 23,002 |
| Awards during the year | **15,445** | 15,639 |
| Vested during the year | **(10,918)** | (15,246) |
| **Outstanding at the end** | **27,922** | 23,395 |

#### 32.6.2 Share-based payments income statement charge

| | **Rs.'000** | Rs.'000 |
|---|---|---|
| Restricted and performance share awards | **13,758** | 14,977 |
| Share award option plans | **367** | 1,087 |
| | **14,125** | 16,064 |

## 33 Events occurring after the reporting date

Subsequent to the reporting date, no circumstances have arisen which would require adjustment to or disclosure in the financial statements.

## 34 Comparative figures

The comparative figures and phrases have been re-arranged wherever necessary to conform to the current year's presentation.

## 35 Commitments and contingencies

a. In the normal course of business, the Branch makes various commitments and incurs certain contingent liabilities with legal recourse to its customers. No material losses are anticipated as a result of these transactions.

| | **2016<br>Rs.'000** | **2015<br>Rs.'000** |
|---|---|---|
| Performance bonds | **5,054,268** | 5,690,799 |
| Letters of credit | **10,339,782** | 9,055,949 |
| Other contingent items | **24,951,047** | 16,299,295 |
| Undrawn loan commitments | **178,224,346** | 176,926,467 |
| Foreign exchange contracts | **205,244,944** | 262,960,580 |
| Derivatives - principal amount | **99,979,449** | 131,051,481 |
| Other contra accounts | **16,397,769** | 14,115,977 |
| **Total** | **540,191,605** | 616,100,548 |

**35 Commitments and contingencies (continued)**

**b. Pending litigations against the Branch as at 31st December 2016**

1. Law suit instituted by a former staff (Plaintiff) case no: DSP/214/2011; Plantiff to withdraw the case upon the settlement being recorded in the Labour tribunal. Case was re fixed for 9 Jan 2017 to record the Settlement and to conclude the matter.

2. Court action has been initiated by Christy Lanka Apparels (Pvt) Ltd; a customer of the Branch in proceedings case no: 102/2007/MR; suing the Branch for loss of business and reputation as a result of the Branch purporting to grant increased facilities and later withdrawing them.

3. Court action has been taken under case no.HC/CIVIL/338/12 where case filed by the plaintiff against other three defendants for alleged malicious prosecution. The bank has been enlisted as the 4th defendant for giving evidence on certain transactions of the plaintiff.

4. Plaintiff Millennium Teas Pvt Ltd is suing the bank for breach of duty of care and for acting negligently under court proceeding (Case No. DMR/2275/2012)

5. Seven Labour Tribunal actions have been taken under case numbers LT 2/150/2010, LT 2/315/2012, LT 8/648/12 , LT 13/25/2014, LT 01/32/2016, LT 01/AD/51/2016 and LT 24/478/2016 by former staff members for alleged unfair termination.

6. Case no. 254/2014/DSP filed in District Court of Colombo where the plaintiff Cargills PLC alleges that the recent installation of air condition cooling towers by the Branch in the space between two buildings has caused them inconveniences and nuisance.

7. Travel Club V HSBC , case no - WP/HCCA/Col 180/10(f), Travel Club Ltd has appealed against a verdict given by the District Court of Colombo in favour of HSBC in a case instituted by HSBC for payments due from Travel Club.

8. Law suit instituted by the Plaintiff case No : DLM / 00134 / 2015 has erroneously named HSBC Sri Lanka branch as the second defendant in the case, instead of HSBC Data Processing Limited.

9 The plaintiff instituted action against bank under case no :CHC 40/16 MR alleging that due to of banks`s delay in giving them Bid Bonds they lost the Agency with BB Energy Singapore .

10 Court action has been initiated by H Abeywickrema ; a customer in proceedings case no:DMR 1384/2016; suing the Bank for professional negligence and breach of duty of care as a result of the incorrect overseas travel details been updated and for subsequent collection related activities.

11 Case no. DMR 02342/16 filed in District Court of Colombo where the plaintiff Litro Gas Lanka Limited alleges that the bank has not effected the requested transfer and has hold payment without assigning a reason , due to this additional cost and loss of interest was incurred by the Plaintiff as they had to facilitate the payment through another Bank.

12 Case no. CHC 422/2016 /MR was filed in the Commercial High Court of Colombo by the plaintiff Sourthern Sun Teas (Pvt) Ltd Claiming that the Bank didn`t pay the plaintiff on the Guarantee for USD 1,650,000/- on their demand. The Bank`s defence is that the demand is not in compliance with the conditions of the guarantee.



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**35 Commitments and contingencies (continued)**

**b. Pending litigations against the Branch as at 31st December 2016 (contd)**

13 Law suit instituted by a former staff under case no: 2369/2016/MR , demanding for compensation for causing him the pain of mind futher to his termination from the services of the Bank.

The Branch is of the view that none of the above litigations could result in probable cash outflows that may have any material impact on the financial statements of the Branch.

## 36 Related party disclosure

The Branch carries out transactions in the ordinary course of its business with parties who are defined as related parties in Sri Lanka Accounting Standard (LKAS 24) "Related Party Disclosures", the details of which are reported below.

### 36.1 Transactions with related parties

**( a ) Interest paid to other HSBC Branches and Group Companies**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| **Other HSBC Branches** | | |
| HSBC Hongkong | 1,406,884 | 784,581 |
| | 1,406,884 | 784,581 |
| **Group Companies** | | |
| HSBC London | 44 | 75 |
| HSBC Australia | 151 | 7 |
| HSBC USA | - | 99,744 |
| HSBC Data Processing Ltd | 109,585 | 52,303 |
| HSBC Middle East | 92 | 152 |
| | 109,872 | 152,281 |

**( b ) Interest received from Other HSBC Branches and Group companies**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| **Other HSBC Branches** | | |
| HSBC Hongkong | 100,508 | 14,693 |
| | 100,508 | 14,693 |
| **Group Companies** | | |
| HSBC London | 33 | 23 |
| HSBC Data Processing Ltd | 129 | 126 |
| | 162 | 149 |

**( c ) Commission paid to other HSBC Branches and Group Companies**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| **Other HSBC Branches** | | |
| HSBC New Zealand | 39,125 | 84,339 |
| HSBC Japan | 148 | 142 |
| HSBC Singapore | 213 | 202 |
| HSBC India | 279 | - |
| HSBC Maldives | 148 | - |
| | 39,913 | 84,683 |
| **Group Companies** | | |
| HSBC Canada | 120 | (43) |
| HSBC Melbourne | 549 | - |
| HSBC USA | 1,421 | 1,634 |
| HSBC Data processing Ltd | 20,592 | 68,450 |
| HSBC United Arab Emirates | 823 | 68,450 |
| | 23,505 | 138,491 |

## 36 Related party disclosure (continued)

### 36.1 Transactions with related parties (Continued)

**( d ) Assets of other HSBC Branches and Group Companies**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| **Other HSBC Branches** | | |
| HSBC Hongkong | **41,102,923** | 19,691,997 |
| HSBC New Zealand | **87,656** | 28,172 |
| HSBC Japan | **56,543** | 22,176 |
| HSBC Singapore | **44,931** | 35,335 |
| HSBC India | **611,874** | 168,030 |
| HSBC Thailand | **990** | 493 |
| HSBC Maldives | **195,437** | 108,056 |
| HSBC Malaysia | **-** | 1,076 |
| | **42,100,354** | 20,055,335 |
| **Group Companies** | | |
| HSBC London | **1,046,300** | 366,290 |
| HSBC China (Bank) Co. Ltd | **609** | - |
| HSBC Canada | **84,317** | 30,107 |
| HSBC USA | **3,162,835** | 3,578,537 |
| HSBC UAE | **5,591** | 2,757 |
| HSBC Australia | **123,614** | 60,580 |
| | **4,423,266** | 4,038,271 |

**( e ) Liabilities of other HSBC Branches and Group Companies**

| | 2016 Rs.'000 | 2015 Rs.'000 |
|---|---|---|
| **Other HSBC Branches** | | |
| HSBC Hongkong | **147,064,385** | 128,596,478 |
| HSBC Japan | **618** | 5,798 |
| HSBC Singapore | **403** | 8,769 |
| HSBC India | **114,632** | 19,345 |
| HSBC Bangladesh | **304,718** | 191,199 |
| HSBC Bahrain | **-** | 666 |
| HSBC Maldives | **2,676** | 839 |
| HSBC Malaysia | **-** | 1,043 |
| | **147,487,432** | 128,824,137 |
| **Group Companies** | | |
| HSBC London | **928,823** | 86,880 |
| HSBC Baharain | **840** | - |
| HSBC Canada | **12** | 12 |
| HSBC China (Bank) Co. Ltd | **4,672** | |
| HSBC USA | **1,297,659** | 626,334 |
| HSBC Data Processing Ltd | **1,700,154** | 2,216,865 |
| HSBC Bank Malaysia Berhad | **966** | - |
| HSBC Bank (Singapore) Limited | **10,316** | - |
| HSBC Kuwait | **436** | 499 |
| HSBC Qatar | **2,584** | 1,111 |
| HSBC Dubai | **6,606** | 228 |
| HSBC Australia | **9,680** | 6,888 |
| | **3,962,748** | 2,938,817 |

**36 Related party disclosure (continued)**

**36.2 Transactions with Key Management Personnel (KMP)**

According to Sri Lanka Accounting Standard No. 24 - "Related Party Disclosures", Key Management Personnel are those having authority and responsibility for planning, directing and controlling the activities of the Branch. The Branch has identified Chief Executive Officer, Chief Operating Officer, Chief Risk Officer, Chief Financial Officer, Financial Controller, Senior Internal Audit Manager, Head of Financial Crime Compliance, Acting Head of Regulatory Compliance, Director /Head of Global Markets, General Legal Counsel, Head of Information Technology, Head of Commercial Banking, Head of Retail Banking and Wealth Management, Head of Human Resources and Senior Marketing & Communications Manager as its key management personnel based on the above requirements.

**36.2.a Compensation of KMPs**

| | **2016 Rs.'000** | 2015 Rs.'000 |
|---|---|---|
| Aggregate remuneration paid for the year | **334,294** | 310,276 |
| | **334,294** | 310,276 |

**36.2.b Transactions with KMPs and their close relations**

| | **2016 Rs.'000** | 2015 Rs.'000 |
|---|---|---|
| Total deposits | **129,800** | 105,525 |
| Total accommodation granted | **267,551** | 237,813 |
| | **397,351** | 343,338 |

**37 Segment analysis by line of business**

**Business level performance**

| | **Retail Banking and Wealth Management Rs.'000** | **Commercial Banking Rs.'000** | **Global Banking and Markets Rs.'000** | **Others Rs.'000** | **Total Rs.'000** |
|---|---|---|---|---|---|
| Net operating income | 8,262,716 | 6,995,227 | 6,634,892 | 238,973 | 22,131,808 |
| Operating expenses | (5,838,283) | (2,246,292) | (1,174,494) | (546,452) | (9,805,521) |
| Profit before tax | 2,050,687 | 4,178,463 | 4,718,359 | (310,800) | 10,636,709 |
| Income tax expense | (1,017,863) | (1,199,884) | (1,802,599) | (5,446) | (4,025,792) |
| **Profit after tax** | **1,032,824** | **2,978,579** | **2,915,760** | **(316,246)** | **6,610,917** |
| **Segment assets** | **43,808,998** | **166,643,140** | **174,523,555** | **26,326,980** | **411,302,673** |
| **Segment liabilities and equity** | **118,181,931** | **76,751,536** | **153,425,684** | **62,943,522** | **411,302,673** |

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**38 Investment Fund Account (IFA)**

In terms of the guideline issued by the Central Bank of Sri Lanka dated 29 April 2011 on "Operations of the Investment Fund Account", the following is disclosed; The figures have not been changed from 31 December 2015.

**(a)**

Number of loans granted and total amount outstanding for each purpose, interest rates and tenure of loans : NIL

**(b)** Total investments in government securities as at 31st December 2016, interest rates and maturity :

| Investment amount Rs. | Interest rate | Maturity |
|---|---|---|
| 382,751,310 | 8.65% | 15-Aug-18 |
| 113,566,289 | 8.85% | 15-Jan-19 |
| 57,422,457 | 8.85% | 15-Jan-19 |
| 74,344,569 | 8.92% | 15-Jan-19 |
| 85,136,503 | 8.95% | 15-Jan-19 |
| 89,501,687 | 9.75% | 15-Jan-19 |
| 49,054,293 | 9.75% | 15-Jan-19 |
| 50,928,959 | 10.00% | 1-May-19 |
| 264,479,065 | 14.15% | 1-Nov-19 |
| 111,565,023 | 14.20% | 1-Nov-19 |
| 86,446,265 | 14.30% | 1-Nov-19 |
| 110,836,480 | 14.50% | 1-Nov-19 |
| 77,908,218 | 14.40% | 1-Nov-19 |
| 100,399,598 | 14.40% | 1-Nov-19 |
| 151,093,292 | 14.50% | 1-Nov-19 |
| 101,709,709 | 14.50% | 1-Nov-19 |
| 81,985,306 | 14.40% | 1-Nov-19 |
| 81,073,800 | 12.90% | 1-Nov-19 |
| 78,639,500 | 13.68% | 1-Nov-19 |
| 3,225,386 | 13.40% | 1-Aug-20 |
| 3,578,377 | 11.40% | 1-Aug-20 |
| 12,480,705 | 11.00% | 1-Jan-22 |
| 47,342,368 | 11.60% | 1-May-21 |
| 92,402,230 | 12.00% | 1-May-21 |
| 78,445,204 | 11.60% | 1-May-21 |
| 96,997,512 | 11.60% | 1-May-21 |
| 122,963,298 | 11.40% | 1-May-21 |
| 144,465,650 | 11.55% | 1-May-21 |
| 210,668,248 | 11.72% | 1-May-21 |
| 122,963,298 | 11.45% | 1-May-21 |
| 94,674,453 | 11.50% | 1-May-21 |
| 74,625,964 | 11.53% | 1-May-21 |
| 112,503,258 | 11.50% | 1-May-21 |
| 179,504,200 | 11.56% | 1-May-21 |
| 107,883,720 | 11.55% | 1-May-21 |
| 32,670,648 | 11.60% | 1-May-21 |
| 46,827,097 | 11.64% | 1-May-21 |
| 153,376,581 | 11.03% | 1-May-21 |
| 44,729,200 | 11.23% | 1-May-21 |
| 44,852,100 | 11.24% | 1-May-21 |
| 44,785,250 | 11.20% | 1-May-21 |
| 541,072,950 | 10.00% | 1-May-21 |
| 109,433,500 | 9.50% | 1-Jul-22 |
| 27,431,625 | 9.45% | 1-Jul-22 |
| 121,113,600 | 7.78% | 1-Jul-22 |
| 60,491,400 | 7.80% | 1-Jul-22 |
| 60,524,100 | 7.79% | 1-Jul-22 |
| 60,556,800 | 7.78% | 1-Jul-22 |
| 60,524,100 | 7.79% | 1-Jul-22 |
| 62,873,150 | 7.30% | 1-Jul-22 |
| **5,124,828,295** | | |

Colombo

## 39 Financial Risk Management

### 39.1 Risk management framework

All of the Branch's activities involve, to varying degrees, the analysis, evaluation, acceptance and management of risks or combinations of risks. An established risk governance framework and ownership structure ensures oversight of and accountability for the effective management of risk at Group, regional and global business levels. It also provides for the compliance with the Banking Act No 30 of 1988 as amended by the Banking Amendment Act No 33 of 1995, Directions, Determinations, and Circulars issued to Licensed Commercial Banks by the Central Bank of Sri Lanka. The Branch's Risk Function consists of Wholesale & Market Risk & Retail Banking & Wealth Management (RBWM) Risk, Security & Fraud Risk, CRO & Administration which encapsulate Risk Strategy, Enterprise Wide Stress Testing and Operational Risk. The HSBC Group provides overall written policies and procedures on risk management covering specific areas such as credit risk, liquidity risk, market risk and operational risks. The local management through Executive Committee and Risk Management Committee monitor the execution of risk management policies and procedures.

### 39.2 Credit risk

Credit risk is defined as the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. Credit risk arises principally from cash and cash equivalents, direct lending, trade finance and also from certain other products such as derivative instruments and off balance sheet transactions such as letters of credit and guarantees.

Credit risk:
• Is measured as the amount which could be lost if a customer or counterparty fails to make repayments. In the case of derivatives, the measurement of exposure takes into account the current mark to market value of the contract to the Branch and the expected potential change in that value over time caused by movements in market rates;
• Is monitored within limits, approved by individuals within a framework of delegated authorities. These limits represent the peak exposure or loss to which the Branch could be subjected should the customer or counterparty fail to perform its contractual obligations;
• Is managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.

#### 39.2.1 Credit risk management

The role of the independent credit control unit is fulfilled by the local Risk team which is a part of the Asia Pacific Risk function. Credit approval authorities are delegated by Regional Office (ASP) to Chief Executive Officer (CEO) who in turn delegates limit to local risk executives.

The principle objectives of our credit risk management are;

• To maintain across the Branch a strong culture of responsible lending and a robust risk policy and control framework.
• To both partner and challenge Branch's businesses in defining, implementing and continually re-evaluating our risk appetite under actual and scenario conditions; and
• To ensure there is independent, expert scrutiny of credit risks, their costs and their mitigation.

## 39 Financial risk management (contd)

## 39.2 Credit risk (contd)

### 39.2.1 Credit risk management (contd)

**Credit quality of financial instruments**

Branch's credit risk rating systems and processes are designed to differentiate exposures in order to highlight those with greater risk factors and higher potential severity of loss. In the case of individually significant accounts that are predominantly within the wholesale businesses, the risk ratings are reviewed regularly and any amendments are implemented promptly. Within Branch's retail businesses, risk is assessed and managed using a wide range of risk models to maintain Risk Reward balance.

Branch's risk rating system facilitates the internal ratings-based ('IRB') approach under Basel II adopted by the HSBC Group to support calculation of our minimum credit regulatory capital requirement. Credit quality of customers are assessed taking into account their financial position, past experience and other factors. Special attention is paid to problem exposures in order to accelerate remedial action.

HSBC Group and regional Credit Review and Risk Identification teams regularly review exposures and processes in order to provide an independent, rigorous assessment of credit risk across the Group, reinforce secondary risk management controls and share best practice. Internal audit, as a tertiary control function, focuses on risks with a global perspective and on the design and effectiveness of primary and secondary controls, carrying out oversight audits via the sampling of global / regional control frameworks, themed audits of key or emerging risks and project audits to assess major change initiatives.

**Impairment assessment**

The Branch creates impairment allowances for impaired loans promptly and appropriately.

**Impairment and credit risk mitigation**

The existence of collateral has an impact when calculating impairment on individually assessed impaired loans. When the Branch no longer expect to recover the principal and interest due on a loan in full or in accordance with the original terms and conditions, it is assessed for impairment. If exposures are secured, the current net realizable value of the collateral will be taken into account when assessing the need for an impairment allowance. When the net realizable value of the held collateral is sufficiently adequate to cover the outstanding facilities, requirement for impairment does not occur.

Personal lending portfolios are generally assessed for impairment on a collective basis as the portfolios typically consist of large groups of homogeneous loans. Methodologies used to calculate allowances on a collective basis: a roll rate methodology, discounted recovery methodology or a more basic formulaic approach based on historical losses. For individually assessed impairment, the Discounted Cash Flow methodology is used.

**39 Financial risk management (contd)**

**39.2 Credit risk (contd)**

**39.2.1 Credit risk management (contd)**

**Impairment and credit risk mitigation (contd)**

The historical loss methodology is typically used to calculate collective impairment allowances for secured or low default portfolios which are collectively assessed. The historical loss rate is derived from the average contractual write-off net of recoveries over a defined period. The net contractual write-off rate is the actual amount of loss experienced after the realization of collateral and receipt of recoveries. roll rate methodology also known as the net flow rate methodology is more commonly adopted for unsecured portfolios when there are sufficient volumes of empirical data to develop robust statistical models. In certain circumstances, portfolios have a statistically significant number of defaults and losses available, enabling reliable roll rates to be generated. In these cases a roll rate methodology is applied, and the average loss rate for each delinquency bucket is adjusted to reflect the average loss expected following receipt of recoveries. The average loss expected is derived from average historical collateral realization values.

As an extended method to roll rate methodology, discounted recovery methodology uses the gross contractual loss of the portfolio from the roll rate methodology and determines the recovery out of the gross loss. The Discounted Recovery is then estimated for the recovery at the end of the realization period. Individual impairment is done for the non performing portion of the mortgage portfolio using the Discounted Cash Flow methodology where mortgage accounts are individually assessed to determine the impairment.

For wholesale portfolio, collectively assessed loans' historical loss methodologies are applied to measure loss event impairments which have been incurred but not reported. Loss rates are derived from the observed contractual write off net of recoveries over a defined period. The net contractual write-off rate is the actual amount of loss experienced after realization of collateral and receipt of recoveries. These historical loss rates are adjusted by an economic factor which adjusts the historical averages to better represent current economic conditions affecting the portfolio. In order to reflect the likelihood of a loss event not being identified and assessed, an emergence period assumption is applied. This reflects the period between a loss occurring and its identification. The emergence period is estimated by regional management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. A fixed range for the period between a loss occurring and its identification is assessed empirically on a periodic basis, it may vary over time as these factors change. Given that credit management policies require all customers to be reviewed at least annually, management expects this estimated period would be at most 12 months.

**Write off of loans and receivables**

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

## 39 Financial risk management (contd)

## 39.2 Credit risk (contd)

### 39.2.1 Credit risk management (contd)

**Write off of loans and receivables (contd)**

Credit cards, personal loans and auto loans are generally written off at 180 days. It is done on the billing date of the month, the account reaches 180 days and non performing home loans are written off after 60 months of non recovery. The process is automated and any exception is tracked and manually done the next day. However, early write off could be triggered by the circumstance of the account for example on death, bankruptcy etc.

Usually, collections / recovery activities may continue even after charge off and legal action would be taken if the parties are unable to reach an amicable settlement.

**Collateral management and valuation**

It is the Branch's practice to lend on the basis of the customer's ability to meet their obligations out of cash flow resources rather than rely on the value of collateral which is an important credit risk mitigation mechanism. Depending on the customer's standing and the type of product, facilities may be provided unsecured. However, for other lending, a charge over collateral is obtained and considered in determining the credit decision and pricing. In the event of default, the Branch may utilize the collateral as a source of repayment. Depending on its form, collateral can have a significant financial effect in mitigating our exposure to credit risk.

### 39.2.2 Quantitative disclosures

**Gross loans and receivables**

Gross loans and receivables, impairment and net loans and receivables from customers are disclosed in Note 21 in the financial statements.

Movements in individual and collective impairment during the period are disclosed in Note 21.2 in the financial statements.

**Gross loans and receivables - by product**

| Loans and receivables to other customers | | |
|---|---|---|
| | **2016** | 2015 |
| | **Rs.000** | Rs.000 |
| **By product - local currency** | | |
| Overdrafts | **12,026,830** | 11,717,421 |
| Term loans | **31,369,946** | 33,667,278 |
| Credit cards | **20,521,991** | 19,317,096 |
| Other loans | **327,888** | 634,397 |
| Sub total | **64,246,655** | 65,336,192 |
| **By product - foreign currency** | | |
| Overdrafts | **4,710,339** | 3,356,495 |
| Term loans | **143,739,065** | 113,593,639 |
| Other loans | **1,300,075** | 3,074,818 |
| Sub total | **149,749,479** | 120,024,952 |
| **Total** | **213,996,134** | 185,361,144 |

## 39 Financial risk management (contd)

### 39.2 Credit risk (contd)

### 39.2.2 Quantitative disclosures (contd)

**Gross loans and receivables - by currency**

| | Loans and receivables to other customers | |
|---|---|---|
| | **2016** | 2015 |
| | **Rs.000** | Rs.000 |
| **By product - currency** | | |
| Sri Lankan Rupee | **64,246,656** | 65,336,192 |
| United States Dollar | **141,817,921** | 118,661,642 |
| Great Britain Pound | **411,211** | 524,535 |
| Others | **7,520,347** | 838,775 |
| **Total** | **213,996,134** | 185,361,144 |

**Individual impairment - sector wise analysis**

| | Specific provision - sector wise | |
|---|---|---|
| | **2016** | 2015 |
| | **Rs.000** | Rs.000 |
| **By product - local currency** | | |
| Manufacturing | **623,007** | 590,615 |
| Traders | **14,445** | 4,188 |
| Transport | **1,801** | 25,416 |
| Construction | **-** | - |
| Financial and business services | **51,726** | 39,018 |
| Others | **36,629** | 39,518 |
| **Total** | **727,608** | 698,755 |

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial risk management (contd)

39.2 Credit risk (contd)

39.2.2 Quantitative disclosures (contd)

Gross loans and receivables - sector wise analysis

| Sector | Import bills Rs.000 | Export bills Rs.000 | Overdrafts Rs.000 | Credit Cards Rs.000 | Short term loans Rs.000 | Medium and long term loans Rs.000 | Mortgages Rs.000 | 2016 Total Rs. 000 | 2015 Total Rs. 000 |
|---|---|---|---|---|---|---|---|---|---|
| Agriculture and fishing | - | - | 394,974 | - | - | 8,552,128 | - | **8,947,102** | 4,289,665 |
| Manufacturing | 1,526,828 | 12,013,893 | 4,040,547 | - | 6,919,357 | 24,717,721 | - | **49,218,345** | 51,764,868 |
| Tourism | 26,266 | - | 657,625 | - | - | 28,353,047 | - | **29,036,938** | 16,941,550 |
| Transport | - | - | 363,676 | - | 3,500,633 | 10,771,789 | - | **14,636,098** | 13,523,675 |
| Construction | - | - | 156,728 | - | 317,248 | 2,543,918 | 2,084,630 | **5,102,524** | 4,327,920 |
| Traders | 20,541,977 | 557,525 | 1,973,657 | - | 2,506,279 | 3,603,304 | - | **29,182,741** | 27,278,362 |
| New economy | - | - | 171,739 | - | 1,321,327 | 17,578,729 | - | **19,071,795** | 14,208,398 |
| Financial and business services | - | - | 1,492,618 | - | 2,564,118 | 4,452,756 | - | **8,509,492** | 7,504,023 |
| Infrastructure | - | - | - | - | - | - | - | - | 124,559 |
| Other services | 5,873 | - | 2,445,896 | - | 94,576 | 6,221,048 | - | **8,767,393** | 5,374,270 |
| Credit card | - | - | - | 20,521,991 | - | - | - | **20,521,991** | 19,317,096 |
| Other | - | - | 5,039,708 | - | - | 15,962,007 | - | **21,001,715** | 20,706,758 |
| **Total** | **22,100,943** | **12,571,418** | **16,737,168** | **20,521,991** | **17,223,538** | **122,756,446** | **2,084,630** | **213,996,134** | 185,361,144 |

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

**39 Financial risk management (contd)**

**39.2 Credit risk (contd)**

**39.2.2 Quantitative disclosures (contd)**

**Total gross loans and receivables including acceptances - residual contractual maturity**

| Sector | Less than 7 days Rs.000 | 7-30 Days Rs.000 | 1-3 Months Rs.000 | 3-6 Months Rs.000 | 6-12 Months Rs.000 | 1-3 Years Rs.000 | 3-5 Years Rs.000 | Over 5 years Rs.000 | 2016 Total Rs. 000 | 2015 Total Rs. 000 |
|---|---|---|---|---|---|---|---|---|---|---|
| Overdrafts | 16,737,169 | - | - | - | - | - | - | - | **16,737,169** | 15,073,915 |
| Term lending | 5,798,060 | 20,536,555 | 25,532,839 | 6,573,982 | 2,851,423 | 41,159,625 | 54,902,368 | 11,201,402 | **168,556,254** | 139,773,409 |
| Non-eligible bills | 458,141 | 481,456 | 688,366 | - | - | - | - | - | **1,627,963** | 3,289,278 |
| Money market placements | 1,477,142 | 2,050,000 | 500,000 | - | - | - | - | - | **4,027,142** | 5,399,256 |
| Credit card advances | 20,521,991 | - | - | - | - | - | - | - | **20,521,991** | 19,317,096 |
| Mortgages | 507,527 | 175 | 153 | 11,705 | 10,343 | 66,711 | 130,882 | 1,798,119 | **2,525,615** | 2,508,302 |
| **Total gross loans and receivables** | **45,500,030** | **23,068,186** | **26,721,358** | **6,585,687** | **2,861,766** | **41,226,336** | **55,033,250** | **12,999,521** | **213,996,134** | 185,361,144 |
| Acceptances | 422,945 | 1,821,941 | 1,811,126 | 843,715 | 878,422 | 728,569 | - | - | **6,506,718** | 10,395,323 |
| **Total** | **45,922,975** | **24,890,127** | **28,532,484** | **7,429,402** | **3,740,188** | **41,954,905** | **55,033,250** | **12,999,521** | **220,502,852** | 195,756,467 |

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

**39 Financial risk management (contd)**

**39.2 Credit risk (contd)**

**39.2.2 Quantitative disclosures (contd)**

**Distribution of financial instruments by credit quality**

| Sector | Strong Rs.000 | Good Rs.000 | Satisfactory Rs.000 | Sub Standard Rs.000 | Past due but not impaired Rs.000 | Impaired Rs.000 | Impairment Allowance Rs.000 | 2016 Total Rs. 000 | 2015 Total Rs. 000 |
|---|---|---|---|---|---|---|---|---|---|
| Cash and cash equivalents | 1,184,525 | 6,203,783 | - | - | - | - | - | **7,388,308** | 5,813,230 |
| Balances with Central bank | 9,090,026 | - | - | - | - | - | - | **9,090,026** | 6,724,825 |
| Placements with banks | - | 40,524,300 | - | - | - | - | - | **40,524,300** | 19,469,700 |
| Derivative financial instruments | 100,655 | 201,669 | 169,433 | - | - | - | - | **471,757** | 2,078,082 |
| Other financial assets held-for-trading | 756,106 | - | - | - | - | - | - | **756,106** | 330,826 |
| Loans and receivables to banks | - | - | - | - | - | - | - | - | 15,784,400 |
| Loans and receivables to other customers | 908,323 | 7,592,144 | 184,614,078 | 11,791,029 | 6,830,698 | 2,259,862 | (1,121,050) | **212,875,084** | 184,328,632 |
| Financial investments AFS | 122,514,575 | - | - | - | - | - | - | **122,514,575** | 131,828,703 |
| Acceptances | - | - | 4,990,544 | 1,283,547 | 232,627 | - | - | **6,506,718** | 10,395,323 |
| **Total** | **134,554,211** | **54,521,896** | **189,774,055** | **13,074,576** | **7,063,325** | **2,259,862** | **(1,121,050)** | **400,126,875** | 376,753,721 |

**39 Financial risk management (contd)**

**39.2 Credit risk (contd)**

**39.2.2 Quantitative disclosures (contd)**

**Ageing analysis of loans and advances - past due but not impaired**

| Sector | Contractual residual maturity | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less than 7 days Rs.000 | 7-30 Days Rs.000 | 1-3 Months Rs.000 | 3-6 Months Rs.000 | 6-12 Months Rs.000 | 1-3 Years Rs.000 | 3-5 Years Rs.000 | Over 5 years Rs.000 | Total Rs. 000 |
| 2016 | **1,894,481** | **1,056** | **56,262** | **10,705** | **841,213** | **2,584,793** | **1,105,950** | **336,238** | **6,830,698** |
| 2015 | 1,545,829 | 143 | 4,562 | 12,616 | 28,848 | 715,022 | 3,966,078 | 2,975,262 | 9,248,360 |

The impairment charges for loans and receivables is disclosed in Note 10. The movement in provision for impairment is disclosed in Note 21.2

**Collateral held and other credit enhancements and their financial effect**

| | 2016 | | 2015 | |
|---|---|---|---|---|
| | Carrying Amount LKR'000 | Carrying Amount LKR'000 | Carrying Amount LKR'000 | Carrying Amount LKR'000 |
| Loans and receivables to banks | - | - | 15,784,400 | - |
| Loans and receivables to other customers | 212,875,084 | 78,854,865 | 184,328,632 | 67,473,431 |

**39.3 Liquidity Risk**

Liquidity and funding risk is the risk that the Branch does not have sufficient financial resources to meet its obligations as they fall due or that it can only do so at excessive cost. Liquidity risk arises from mismatches in the timing of cash flows. Funding risk arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.

Liquidity and funding risk is:
- **Measured** using the European Banking Authority - Delegated Act - Liquidity Coverage Ratio (EBA DA LCR) and Net Stable Funding Ratio (NSFR)
- **Monitored** against the Group's liquidity and funding risk framework and overseen by Regional and local Asset and Liability Management Committees ('ALCO's); and
- **Managed** on a stand-alone basis with no reliance on any related party (unless pre-committed) or the Central Bank of Sri Lanka, unless this represents routine established business as usual market practice.

**39.3.1 Management of liquidity and funding risk**

The Branch uses the HSBC's liquidity and funding risk management framework ('LFRF') that employs two key measures to define, monitor and control the liquidity and funding risk of each of its operating entities. The **Net Stable Funding Ratio ("NSFR")** is used to monitor the structural long-term funding position, and the **Liquidity Coverage Ratio ("LCR")** is used to monitor the resilience to severe liquidity stresses. The NSFR and LCR are monitored on a daily basis by the local management team, with monthly monitoring carried out by the Regional Office.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

**39 Financial risk management (contd)**

**39.3 Liquidity Risk (contd)**

**39.3.1 Management of liquidity and funding risk (Continued)**

**NSFR**
This ratio monitors if the bank has sufficient stable funding to its illiquid assets. The equity and liability side of the balance sheet is considered to "provide" stable funding while on and off balance sheet assets are considered to be "requiring" stable funding. Proportion of stable funding provided/required by each balance sheet item is predetermined based on EBA regulations.

**LCR**
This ratio monitors the ability of the bank to withstand a severe liquidity stress. To ensure resilience under a liquidity stress, the bank is expected to maintain a sufficient stock of High Quality Liquid Assets ("HQLA") which will allow the bank to honour the net cash outflow due within the next 30 days from the start of the stress period. Outflows are assumed to originate from the liabilities of the bank while inflows within the next 30 days are assumed to originate from the assets held by the bank. The outflow and inflow rates are determined based on EBA regulations.

**Maturity analysis of financial liabilities**

| Sector | Less than 7 days Rs.000 | 7-30 Days Rs.000 | 1-3 Months Rs.000 | 3-6 Months Rs.000 | 6-12 Months Rs.000 | 1-3 Years Rs.000 | 3-5 Years Rs.000 | Over 5 years Rs.000 | 2016 Total Rs. 000 | 2015 Total Rs. 000 |
|---|---|---|---|---|---|---|---|---|---|---|
| Due to banks | 14,340,915 | 24,014,400 | - | 9,005,400 | 6,003,600 | 76,215,786 | 17,393,851 | 4,611,182 | **151,585,134** | 129,362,756 |
| Derivative financial instruments | 383,472 | - | - | - | - | - | - | - | **383,472** | 1,814,183 |
| Due to other customers | 98,035,901 | 13,599,617 | 21,241,838 | 16,994,630 | 18,414,729 | 7,081,150 | 7,975,349 | - | **183,343,214** | 182,887,530 |
| Acceptances | 423,129 | 1,821,968 | 1,811,069 | 843,789 | 878,372 | 728,391 | - | - | **6,506,718** | 10,395,323 |
| **Total** | **113,183,417** | **39,435,985** | **23,052,907** | **26,843,819** | **25,296,701** | **84,025,327** | **25,369,200** | **4,611,182** | **341,818,538** | 324,459,792 |

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## 39 Financial risk management (contd)

### 39.4 Market risk

The risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, which will reduce the income or the value of Branch's portfolio is considered as Market risk.

Exposure to market risk is separated into two portfolios:

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

• Non-trading portfolios comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available for sale.

### 39.4.1 Monitoring and limiting market risk exposures

Branch's objective is to manage and control market risk exposures while maintaining a market profile consistent with our risk appetite.

Branch uses a range of tools to monitor and limit market risk exposures, including:

• Sensitivity analysis, the sensitivities of the net present values of asset and expected liability cash flows, in total and by currency, to a one basis point parallel shift in the discount curves used to calculate the net present values.
• Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.
• For foreign exchange risk, the total net short foreign exchange position and the net foreign exchange positions by currency.
• Value at risk ('VAR') which is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence and,
• In recognition of VAR's limitations, the Branch augment VAR with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables.

### 39.4.2 Risk management

Limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set. Group Risk, an independent unit within HSBC Group Head Office, is responsible for our market risk management policies and measurement techniques. Each of major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

**39 Financial risk management (contd)**

**39.4 Market risk (contd)**

**39.4.2 Risk management (contd)**

Both the VAR and Stressed VAR models the Branch uses are based predominantly on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking into account interrelationships between different markets and rates such as interest rates and foreign exchange rates.

The historical simulation models used incorporate the following features:

- Historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities;
- Potential market movements utilized for VAR are calculated with reference to data from the past two years,
- Potential market movements employed for stressed VAR calculations are based on a continuous one year period of stress for the trading portfolio

Branch routinely validates the accuracy of the VAR models by back-testing the actual daily profit and loss results, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers.

**FX Currency open positions**
This represent the net open positions of all currencies as at year end.

| Currency '000 | CHF | EUR | GBP | HKD | JPY | USD | AUD | LKR | CAD | DKK | CNY | MYR | NZD | SEK | SGD | THB | AED |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2016** | **(35.31)** | **(113.34)** | **(22.93)** | **25.46** | **(68.50)** | **11,681.00** | **(52.27)** | **(11,341.00)** | **(2.53)** | **4.29** | **(15.23)** | **-** | **(34.19)** | **(12.66)** | **43.01** | **(52.01)** | **(4.00)** |
| 2015 | (60.67) | 35.42 | (24.58) | 118.26 | (2.26) | 12,068.57 | 3.03 | (12,203.57) | 3.17 | 12.27 | 38.33 | 7.46 | 4.60 | 31.16 | (31.86) | (2.12) | 2.78 |

**Sensitivity of reported reserves to interest rate movements**

| AFS Reserve (Currency wise) USD'000 | 2016 | | |
|---|---|---|---|
| | Month end balances | +100bps | -100 bps |
| USD | (1,958) | (742) | 742 |
| LKR | (7,263) | (7,207) | 7,207 |
| **AFS Total** | **(9,221)** | **(7,949)** | **7,949** |

| AFS Reserve (Currency wise) USD'000 | 2015 | | |
|---|---|---|---|
| | Month end balances | +100bps | -100 bps |
| USD | (1,269) | (913) | 913 |
| LKR | (3,445) | (5,257) | 5,257 |
| **AFS Total** | **(4,714)** | **(6,170)** | **6,170** |

**Net Interest Income (NII) sensitivity calculations**

The Branch has two standard scenarios; the parallel movement in the yield curve by +/-100 bps (the 100bps bullet scenario) and the +/-100bps ramp scenario, whereby rates are assumed to rise/fall in parallel by 25bps on the first day of each quarter. The interest rate sensitivity of the Trading book and the rest of the Branch must be separately analysed. The split should take account of internal transfer pricing deals and is important for management analysis and reporting.

The sensitivity calculations reflect the best estimates of the future movements in NII under the prescribed scenarios.

**39 Financial risk management (contd)**

**39.4 Market risk (continued)**

**39.4.2 Risk management (contd)**

**Interest rate sensitivity analysis**

| USD'000 | Retail Banking | Corporate Banking | Global Banking | Total Retail and Commercial Banking | ALCO Pool | Treasury /Global Markets | Total |
|---|---|---|---|---|---|---|---|
| **Projected NII of the next twelve** | **43,587** | **29,977** | **3,956** | **77,520** | **1,492** | **37,215** | **116,227** |
| **Incremental NII of the next twelve** | | | | | | | |
| Parallel movements in yield curve | | | | | | | |
| +100 bps | (639) | 383 | 253 | (3) | 2,252 | 6,088 | 8,337 |
| -100 bps | 410 | (1,669) | (269) | (1,528) | (1,134) | (6,042) | (9,265) |
| Ramp movements in yield curve* | | | | | | | |
| +100 bps | (386) | 178 | 158 | (51) | 1,361 | 3,933 | 5,243 |
| -100 bps | 261 | (772) | (171) | (682) | (1,134) | (3,971) | (5,788) |

**Projected NII of the thirteenth month to twenty fourth month**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Base case | **43,587** | **29,977** | **3,956** | **77,520** | **1,492** | **37,215** | **116,227** |
| With +100 bps in 1st year | 43,131 | 30,625 | 4,208 | 77,965 | 4,964 | 41,626 | 124,555 |
| Difference | **(456)** | **648** | **252** | **445** | **3,472** | **4,411** | **8,328** |
| With -100 bps in 1st year | 43,793 | 28,043 | 3,687 | 75,523 | (867) | 32,293 | 106,950 |
| Difference | **206** | **(1,934)** | **(269)** | **(1,997)** | **(2,359)** | **(4,922)** | **(9,277)** |

* Rates are assumed to rise / fall in parallel by 25bps on the first day of each quarter.

**39 Financial risk management (contd)**

**39.5 Operational risk**

The objective of our operational risk management is to manage and control operational risk in a cost effective manner within targeted levels of operational risk consistent with our risk appetite.

A formal governance structure provides oversight over the management of operational risk. A country level risk Management meeting is held on a monthly basis to discuss key risk issues and review the effective implementation of our operational risk management framework.

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

A centralized database is used to record the results of the operational risk management process. Operational risk self-assessments are input and maintained by business units. To ensure that operational risk losses are consistently reported and monitored at HSBC Group level, all branches are required to report individual losses in excess of a particular threshold.

## 39 Financial risk management (contd)

## 39.5 Operational risk (contd)

### 39.5.1 Capital management

**Qualitative disclosures**

The Bank's capital is segregated into Tier 1 and Tier 2 Capital:

Tier 1 capital – core capital

This includes assigned capital, statutory reserve fund, published retained profits, general and other reserves. The assigned capital is the amount provided by HSBC Asia Pacific to conduct its operations in Sri Lanka.

Tier 2 capital – supplementary capital

Revaluation reserves is the main constituent of supplementary capital for the Bank. As per the CBSL regulations, a prudential revaluation is done reflecting the full possibility of price fluctuations and forced sale, with prior approval from CBSL, which is then subject to a discount of 50%.

Upon the introduction of LKAS 32/39, general provision/collective impairment is not included in the accounts, hence Tier 2 will reflect NIL provision amounts from 2012 onwards.

| **Composition of regulatory capital (Audited)** | **2016**<br>**Rs'000** | 2015<br>Rs'000 |
|---|---|---|
| Assigned capital | **3,152,358** | 3,152,358 |
| Statutory reserve fund | **2,222,693** | 2,090,475 |
| Published retained profits | **37,475,748** | 32,964,267 |
| General and other reserves | **10,282,164** | 9,320,266 |
| **Total qualifying tier 1 capital prior to deductions** | **53,132,963** | 47,527,366 |
| | | |
| **Deductions to tier 1 capital** | **531,603** | 203,461 |
| Net deferred tax assets | **545,073** | 360,117 |
| Amounts due to head office and branches outside Sri Lanka in Sri Lanka Rupees (-) - represent only Rupee assets | **(13,470)** | (156,656) |
| Amounts due from head office and branches outside Sri Lanka in Foreign Currency (Net) | | |
| | | |
| **Tier 1 capital** | **52,601,360** | 47,323,905 |
| | | |
| **Components of tier 2 capital** | | |
| Revaluation Reserves (as approved by CBSL) | **356,917** | 356,917 |
| General Provisions* | **-** | - |
| **Total qualifying tier 2 capital prior to deductions** | **356,917** | 356,917 |
| | | |
| **Tier 3 capital** | **-** | - |
| | | |
| **Total capital** | **52,958,277** | 47,680,822 |

* Note: As per the LKAS 32/39 which came into effect on 1 January 2012, instructs to exclude general provision from accounts, hence Tier 2 general provision is zero.

**39 Financial risk management (contd)**

**39.5 Operational risk (contd)**

**39.5.1 Capital management(contd)**

**Capital adequacy**

HSBC Sri Lanka follows the capital planning and guidance as set out by its group office, while ensuring that all requirements as set out by the local regulator are complied with. In the matter of capital planning, the Branch relies on the monthly stress testing carried out in form of the Economic Value of Equity (EVE) calculation, to evaluate capital adequacy. An annual stress testing on credit risk is also carried out to establish the relevant impact on capital.

The Branch maintains records of Risk Weighted Assets (RWA) based on both the local regulatory requirement as set out by CBSL as well as on the basis set out by the Prudential Regulatory Authority (PRA) of the United Kingdom. Growth of the balance sheet is subject to RWA limits on the PRA basis, which are set and monitored by the Regional Office. Assets, Liabilities and Capital Management (ALCM) monitors growth against these limits and works closely with the Businesses to ensure that any increased growth meets with the expected returns on such growth.

All growth measures as targeted in the Annual Operating Plan (AOP) are reviewed in line with impact to Capital Adequacy Ratio (CAR) limits set by CBSL. Any remittance of profit to Regional office is evaluated in terms of impact to CAR. Further, exchange rate fluctuations to a maximum of 20% are taken into account when forecasting CAR, which is carried out on a monthly basis. HSBC Sri Lanka will ensure that all business growth and profit remittances are carried out in full compliance with the prudential limits set by CBSL, while ensuring sufficient capital to absorb the impact of a 20% movement in foreign exchange rates. The minimum expected CAR will ensure optimal single borrower limits, optimal deposit insurance fee levels and also ensure ability to continue derivative trading activity.

| **Risk-weighted assets (Un-audited)** | **2016** | 2015 |
|---|---|---|
| | **Rs.'000** | Rs.'000 |
| Credit risk | **204,167,278** | 171,525,469 |
| Market risk | **19,527,360** | 14,036,015 |
| Operational risk | **32,748,405** | 33,289,367 |
| **Total risk-weighted assets** | **256,443,043** | 218,850,851 |
| **Capital ratios** | | |
| Tier 1 ratio | **20.51%** | 21.62% |
| Total capital ratio | **20.65%** | 21.79% |

**39.5.2 Exposure to stock market (Un-audited)**

In terms of the Central Bank of Sri Lanka Direction No 03 of 2011 on "Exposure to Stock Market", the following are outstanding exposures as at the reporting date:

| | **2016** | 2015 |
|---|---|---|
| | **Rs. '000** | Rs. '000 |
| On Balance sheet exposure | **203,590** | 191,544 |
| Off Balance sheet exposure | **Nil** | Nil |

## 40 Fair value of financial assets and liabilities

### 40.1 Fair value of financial instruments not carried at fair value

| | Carrying Value Rs'000 | Fair Value Rs'000 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents | 7,388,309 | 7,388,309 |
| Balances with Central Bank | 9,090,026 | 9,090,026 |
| Placements with banks | 40,524,300 | 40,524,300 |
| Loans and receivables to banks | - | - |
| Loans and receivables to other customers | 212,875,084 | 218,891,316 |
| Acceptances and endorsements | 6,506,718 | 6,506,718 |
| **Liabilities** | | |
| Due to banks | 151,585,134 | 151,585,134 |
| Due to customers | 183,343,212 | 183,343,212 |
| Acceptances and endorsements | 6,506,718 | 6,506,718 |

**Note:**

The above list of financial instruments excluding "loans and receivables to other customers" have carrying amounts that are reasonable approximations of fair value since they are short term in nature or re-priced to current market rates frequently.

## 40 Fair value of financial assets and liabilities (contd)

### 40.2 Fair value of financial instruments carried at fair value

#### 40.2.1 Fair value hierarchy

Fair values of financial assets and liabilities are determined according to the following hierarchy:

• Level 1 – valuation technique using quoted market price: financial instruments with quoted prices for identical instruments in active markets that the branch can access at the measurement date.

• Level 2 – valuation technique using observable inputs: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or valued using models where all significant inputs are observable. Similar instruments in inactive markets and financial instruments.

• Level 3 – valuation technique with significant unobservable inputs: financial instruments valued using valuation.

**Financial instruments carried at fair value and bases of valuation**

| As at 31 December 2016 | Level 1 Rs'000 | Level 2 Rs'000 | Level 3 Rs'000 |
|---|---|---|---|
| **Assets** | | | |
| Other financial assets held-for-trading | - | 756,106 | - |
| Derivative financial instruments | 9,372 | 462,385 | - |
| Financial investments : Available-for-sale | - | 122,514,575 | - |
| | 9,372 | 123,733,066 | - |
| **Liabilities** | | | |
| Derivatives | 2,481 | 380,991 | - |
| | 2,481 | 380,991 | - |
| **As at 31 December 2015** | | | |
| **Assets** | | | |
| Other financial assets held-for-trading | - | 330,825 | - |
| Derivative financial instruments | 32,133 | 1,950,688 | 95,261 |
| Financial investments : Available-for-sale | - | 131,828,703 | - |
| | 32,133 | 134,110,216 | 95,261 |
| **Liabilities** | | | |
| Derivative financial instruments | 5,324 | 1,808,516 | 343 |
| | 5,324 | 1,808,516 | 343 |

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## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

## AS AT 31 DECEMBER

### 40 Fair value of financial assets and liabilities

### 40.2 Fair value of financial instruments carried at fair value (contd)

### 40.2.1 Fair Value Hierarchy (contd)

**Movement in Level 3 financial instruments**

| | 2016 | |
|---|---|---|
| | **Assets** | **Liabilities** |
| | **Rs'000** | **Rs'000** |
| As at 1 January | 95,261 | 343 |
| Total losses recognised in income statement | (95,261) | (343) |
| Settlements | - | - |
| **As at 31 December** | **(0)** | **(0)** |

| | 2015 | |
|---|---|---|
| | **Assets** | **Liabilities** |
| | **Rs'000** | **Rs'000** |
| As at 1 January | 112,944 | 113,718 |
| Total losses recognised in profit or loss | (9,247) | (104,257) |
| Settlements | (8,436) | (9,118) |
| **As at 31 December** | **95,261** | **343** |

### 40.2.2 Valuation of financial instruments

The best evidence of fair value is a quoted price in an actively traded principal market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market, the fair value of the total holding of the financial instrument is calculated as the product of the number of units and quoted price. The judgment as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. Valuation techniques may incorporate assumptions about factors that other market participants would use in their valuations, including:

• the likelihood and expected timing of future cash flows on the instrument. Judgement may be required to assess the counterparty's ability to service the instrument in accordance with its contractual terms. Future cash flows may be sensitive to changes in market rates;

• selecting an appropriate discount rate for the instrument. Judgement is required to assess what a market participant would regard as the appropriate spread of the rate for an instrument over the appropriate risk-free rate;

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**40 Fair value of financial assets and liabilities**

**40.2 Fair value of financial instruments carried at fair value (contd)**

**40.2.2 Valuation of financial instruments (contd)**

• judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products. A range of valuation techniques is employed, dependent on the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analyses, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to considering credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap.

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the measurement of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit or greater than 5% of the instrument's valuation is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur.

**Control framework**

Fair values are subject to a control framework designed to ensure that they are either determined or validated by a function independent of the risk-taker.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets branch will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, inter alia:

- the extent to which prices may be expected to represent genuine traded or tradable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the balance sheet date;
- the manner in which the data was sourced.

**Fair value adjustments**

Fair value adjustments are adopted when HSBC considers that there are additional factors that would be considered by a market participant which are not incorporated within the valuation model. HSBC classifies fair value adjustments as either 'risk-related' or 'model-related'. Movements in the level of fair value adjustments do not necessarily result in the recognition of profits or losses within the income statement. For example, as models are enhanced, fair value adjustments may no longer be required. Similarly, fair value adjustments will decrease when the related positions are unwound, but this may not result in profit or loss.