THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED SRI LANKA BRANCH

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH

FOR THE YEAR ENDED 31 DECEMBER 2017

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[Confidential]

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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 2017, 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 75.

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 position of the Branch as at 31 December 2017, and of their financial performance and cash flows for the year then ended, in accordance with Sri Lanka Accounting Standards.

28 March 2018
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	2017 Rs.'000	2016 Rs.'000
Interest income		**28,445,719**	25,738,799
Interest expenses		**(10,303,277)**	(8,446,028)
Net interest income	5	**18,142,442**	17,292,771
Fee and commission income		**3,680,452**	3,484,406
Fee and commission expenses		**(882,970)**	(632,242)
Net fee and commission income	6	**2,797,482**	2,852,164
Net gain from trading	7	**1,889,192**	2,145,086
Net gain / (loss) from financial investments	8	**307,951**	(5,910)
Other operating income (net)	9	**51,583**	49,675
Total operating income		**23,188,650**	22,333,786
Impairment charge for loans and other losses	10	**(248,563)**	(201,978)
Net operating income		**22,940,087**	22,131,808
Personnel expenses	11	**(3,492,303)**	(3,247,346)
Other expenses	12	**(6,806,474)**	(6,558,175)
Operating profit before Value Added Tax (VAT) and Nation Building Tax (NBT)		**12,641,310**	12,326,287
Value Added Tax (VAT) and Nation Building Tax (NBT)		**(1,932,302)**	(1,689,578)
Profit before tax		**10,709,008**	10,636,709
Income tax expense	13	**(4,300,974)**	(4,025,792)
Profit for the year		**6,408,034**	6,610,917

Figures in brackets indicate deductions.

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The financial statements are to be read in conjunction with the related notes as set out on pages 7 to 75, which form an integral part of the financial statements of the Branch. The Report of the Auditors is given on page 1.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
STATEMENT OF OTHER COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 DECEMBER	**Note**	**2017 Rs.'000**	2016 Rs.'000
Profit for the year		**6,408,034**	6,610,917
Other comprehensive income/(expenses)			
Items that may be reclassified to profit or loss in subsequent periods			
Gain /(loss) on re-measuring available-for-sale financial assets		**2,409,308**	(696,655)
Gain from the financial statements of foreign currency operation		**626,846**	962,728
Tax relating to components of other comprehensive income	**13.d**	**(676,693)**	197,149
Net other comprehensive income that may be reclassified to profit or loss in subsequent periods		**2,359,461**	**463,222**
Items that may not be reclassified to profit or loss in subsequent periods			
Actuarial loss on defined benefit plans		**(218,746)**	(60,294)
Gain on revaluation of property plant and equipment		**462,482**	197,641
Tax relating to components of other comprehensive income	**13.d**	**35,114**	**(27,245)**
Net other comprehensive income that may not be reclassified to profit or loss in subsequent periods		**278,850**	**110,102**
Total comprehensive income for the year		**9,046,345**	**7,184,241**

Figures in brackets indicate deductions.

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THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
STATEMENT OF FINANCIAL POSITION

AS AT 31 DECEMBER	Note	2017 Rs.'000	2016 Rs.'000
ASSETS			
Cash and cash equivalents	15	7,721,011	7,388,309
Balances with the Central Bank of Sri Lanka	16	7,765,246	9,090,026
Placements with banks	17	41,214,750	40,524,300
Derivative financial instruments	18	1,265,432	471,757
Other financial assets held-for-trading	19	4,762,430	756,106
Loans and receivables from banks	20	-	-
Loans and receivables from other customers	21	202,739,049	212,875,084
Financial investments – available-for-sale	22	150,869,348	122,514,575
Property, plant and equipment	23	3,940,743	3,737,377
Deferred tax asset	24	-	545,073
Other assets	25	14,627,602	13,400,066
Total Assets		434,905,611	411,302,673
LIABILITIES			
Due to banks	26	175,400,730	151,585,134
Derivative financial instruments	27	1,032,710	383,472
Due to other customers	28	180,725,041	183,343,212
Current tax liabilities		1,923,018	1,720,293
Deferred tax liabilities	24	106,271	-
Other liabilities	29	18,870,111	20,027,040
Total Liabilities		378,057,881	357,059,151
EQUITY			
Assigned capital	30	3,152,358	3,152,358
Statutory reserve fund	31	2,350,855	2,222,693
Other reserves	32	14,171,169	11,392,723
Retained earnings		37,173,348	37,475,748
Total Equity		56,847,730	54,243,522
Total equity and liabilities		434,905,611	411,302,673
Contingent liabilities and commitments	35	533,264,306	540,191,605

The financial statements are to be read in conjunction with the related notes as set out on pages 7 to 75, which form an integral 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 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

28th March 2018
Colombo

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THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 2017	Assigned Capital Rs.'000	Exchange Equalisation of Capital Rs.'000	Exchange Equalisation of Reserve 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 2016	3,152,358	-	4,039,608	5,108,459	(489,466)	172,198	2,090,476	1,957,210	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	-	-	-	-	-	(828)	132,218	-	(132,218)	(828)
Cost of share options granted during the year	-	-	-	-	-	-	-	-	-	-
Change in fair value of restricted share awards	-	-	-	-	-	-	-	-	-	-
Depreciation on revaluation reserve	-	-	-		-	-	-	(19,915)	19,915	-
Deferred tax on revaluation								(1,389)	1,389	-
Profit transferred to head office	-	-	-	-	-	-	-	-	(1,935,000)	(1,935,000)
Total transactions with equity holders	-	-	-	-	-	(828)	132,218	(21,304)	(2,045,914)	(1,935,828)
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
Balance as at 1 January 2017	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
Total comprehensive income for the year										
Profit for the year	-	-	-	-	-	-	-	-	6,408,034	6,408,034
Other comprehensive income (net of tax)	-	-	626,846	-	1,732,616	-	-	425,803	(146,954)	2,638,311
Total comprehensive income for the year	-	-	626,846	-	1,732,616	-	-	425,803	6,261,080	9,046,345
Transactions with equity holders, recognised directly in equity										
Transfers to reserves during the year	-	-	-	-	-	(3,135)	128,162	-	(128,162)	(3,135)
Restricted shares	-	-	-	-	-	-	-	-	(13,826)	(13,826)
Profit transferred to head office	-	-	-	-	-	-	-	-	-	-
Deferred tax on revaluation reserve	-	-	-	-	-	-	-	1,435	(1,435)	-
Depreciation on revaluation reserve	-	-	-	-	-	-	-	(5,119)	5,119	-
Transfer to IFA reserve								-	-	-
Profit transferred to head office	-	-	-	-	-	-	-	-	(6,425,177)	(6,425,177)
Total transactions with equity holders	-	-	-	-	-	(3,135)	128,162	(3,684)	(6,563,480)	(6,442,137)
Balance as at 31 December 2017	3,152,358	-	5,629,182	5,108,459	743,645	168,234	2,350,855	2,521,649	37,173,348	56,847,730

Figures in brackets indicate deductions.

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THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
CASH FLOW STATEMENT

FOR THE YEAR ENDED 31 DECEMBER	2017	2016
	Rs.'000	Rs.'000
Cash flow from operating activities		
Interest received	27,603,791	24,209,937
Interest paid	(12,981,530)	(6,166,626)
Recoveries on previously written off loans	391,120	204,908
Fees and commission received	2,797,482	2,852,164
Dividends received	-	-
Net receipts from trading activities	1,889,192	2,154,880
Net receipts from investing activities	307,951	(5,910)
Operating expenses paid	(9,781,114)	(9,233,463)
Operating profit before changes in operating assets and liabilities	10,226,892	14,015,890
Changes in operating assets and liabilities		
Decrease in treasury bills and other eligible bills	350,996	39,231,598
Increase in treasury bonds	(19,441,903)	(27,815,617)
Increase in loans to other banks	(690,450)	(5,270,200)
Decrease / (increase) in loans and advances	9,740,514	(27,419,151)
Increase in government bonds	(10,846,626)	(3,224,974)
(Increase)/decrease in other assets	(1,929,073)	802,764
(Decrease) / increase in deposits from customers	(2,618,171)	455,682
Increase in borrowings	23,815,596	22,222,378
Increase/(decrease) in other liabilities	2,612,630	(1,692,248)
Cash generated from / (used in) operating activities	993,513	(2,709,768)
Income tax paid	(6,373,170)	(6,171,416)
Net cash flows generated from operating activities	4,847,236	5,134,707
Cash flow from investing activities		
Proceeds from disposal of property, plant and equipment	25,933	16,877
Acquisition of property, plant and equipment	(52,838)	(239,411)
Net cash flows used in investing activities	(26,905)	(222,534)
Cash flow from financing activities		
Profit transferred to Head Office	(6,425,177)	(1,935,000)
Net cash flows used in financing activities	(6,425,177)	(1,935,000)
Net (decrease)/increase in cash and cash equivalents	(1,604,846)	2,977,173
Cash and cash equivalents at the beginning of period	16,478,335	12,538,055
Exchange adjustment	612,768	963,107
Cash and cash equivalents at the end of the year (Note A)	15,486,257	16,478,335

Note A
Analysis of cash and cash equivalents at the end of the year

	2017	2016
Cash in hand and balances with banks	1,287,738	1,184,525
Balances with other banks	6,433,273	6,203,784
Balances with Central Bank	7,765,246	9,090,026
	15,486,257	16,478,335

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 75, which form an integral part of the financial statements of the Branch. The Report of the Auditors is given on page 1.

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1. CORPORATE INFORMATION

1.1 Domicile and legal form

The HongKong and Shanghai Banking Corporation Limited is a public limited liability company incorporated in Hong Kong 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.

1.3 Parent company and ultimate parent company

The immediate parent entity is the Hongkong and Shanghai Banking Corporation Limited incorporated in Hongkong 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, relevant interpretations of the Standard Interpretations Committee ("SIC"), International Financial Reporting Interpretations Committee ("IFRIC") 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 recognised as the present value of the defined benefit obligation;
- Freehold land and buildings 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).

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2. BASIS OF PREPARATION (CONTINUED)

2.4 Use of estimates and judgement

The preparation of financial statements require management to make judgement 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 recognised 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 2017

The following standards and interpretations apply for the first time to financial reporting periods commencing on or after 1 January 2017:

(i) Amendments to LKAS 12 - Recognition of Deferred Tax Assets for Unrealised Losses

Amendments made to LKAS 12 clarify the accounting for deferred tax where an asset is measured at fair value and that fair value is below the asset's tax base. Specifically, the amendments confirm that:

- A temporary difference exists whenever the carrying amount of an asset is less than its tax base at the end of the reporting period.
- An entity can assume that it will recover an amount higher than the carrying amount of an asset to estimate its future taxable profit.
- Where the tax law restricts the source of taxable profits against which particular types of deferred tax assets can be recovered, the recoverability of the deferred tax assets can only be assessed in combination with other deferred tax assets of the same type.
- Tax deductions resulting from the reversal of deferred tax assets are excluded from the estimated future taxable profit that is used to evaluate the recoverability of those assets.

(ii) Amendments to LKAS 7 - Disclosure Initiative

An entities will be required to explain changes in their liabilities arising from financing activities. This includes changes arising from cash flows (Eg - drawdowns and repayments of borrowings) and non-cash changes such as acquisitions, disposals, accretion of interest and unrealised exchange differences.

Changes in financial assets must be included in this disclosure if the cash flows were, or will be, included in cash flows from financing activities. This could be the case, for example, for assets that hedge liabilities arising from financing liabilities.

2. BASIS OF PREPARATION (CONTINUED)

2.5 Changes in accounting standards (contd)

(a) New accounting standards, amendments and interpretations adopted in 2017 (contd)

Entities may include changes in other items as part of this disclosure, for example by providing a 'net debt' reconciliation. However, in this case the changes in the other items must be disclosed separately from the changes in liabilities arising from financing activities.

(iii) Amendments to SLFRS 12 'Disclosure of interests in other entities' regarding clarification of the scope of the standard.

The amendments clarify that the disclosure requirements of SLFRS 12 apply to interests in entities that are classified as held for sale, except for the summarised financial information.

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

The following standards and interpretations had been issued but not mandatory for annual reporting periods ending 31 December 2017.

(i) SLFRS 9 Financial Instruments and associated amendments to various other standards

SLFRS 9 replaces the multiple classification and measurement models in LKAS 39 Financial instruments: Recognition and measurement with a single model that has initially only two classification categories: amortised cost and fair value.

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 if: a) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows, and b) the contractual cash flows under the instrument solely represent payments of 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 statement of profit or loss, except for equity investments that are not held for trading, which may be recorded in the statement of profit or loss or in reserves (without subsequent recycling to profit or loss).

For financial liabilities that are measured under the fair value option entities will need to recognise the part of the fair value change that is due to changes in the their own credit risk in other comprehensive income rather than profit or loss.

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2. BASIS OF PREPARATION (CONTINUED)

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. The new standard also introduces expanded disclosure requirements and changes in presentation.

Further changes introduced to the classification and measurement rules and also introduced a new impairment model to SLFRS 9. The changes introduce:

- a third measurement category (FVOCI) for certain financial assets that are debt instruments
- a new expected credit loss (ECL) model which involves a three-stage approach whereby financial assets move through the three stages as their credit quality changes. The stage dictates how an entity measures impairment losses and applies the effective interest rate method. A simplified approach is permitted for financial assets that do not have a significant financing component (eg trade receivables). On initial recognition, entities will record a day-1 loss equal to the 12 month ECL (or lifetime ECL for trade receivables), unless the assets are considered credit impaired.

The standard is effective for the annual periods beginning on or after 1 January 2018.

The impact of transitioning to SLFRS 9 at 1 January 2018 on the financial statements of HSBC Sri Lanka was a decrease in net assets of LKR 1,714,173,449 arising from additional impairment allowances. The increase in net deferred tax assets was LKR 479,968,565.

The overall impact of transition on the Core Tier 1 ratio is a decrease of 65 bps.

Amendments to SLFRS 9 Financial Instruments - Prepayment Features with Negative Compensation: This amendment confirm that when a financial liability measured at amortised cost is modified without this resulting in de-recognition, a gain or loss should be recognised immediately in profit or loss. The gain or loss is calculated as the difference between the original contractual cash flows and the modified cash flows discounted at the original effective interest rate. This means that the difference cannot be spread over the remaining life of the instrument which may be a change in practice from LKAS 39.

The amendment is effective for annual periods beginning on or after 1 January 2019.

(ii) SLFRS 15 Revenue from contracts with customers and associated amendments to various other standards

SLFRS 15 will replace LKAS 18 which covers contracts for goods and services and LKAS 11 which covers construction contracts. The new standard is based on the principle that revenue is recognised when control of a good or service transfers to a customer – so the notion of control replaces the existing notion of risks and rewards.

2. BASIS OF PREPARATION (CONTINUED)

2.5 Changes in accounting standards (contd)

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

A new five-step process must be applied before revenue can be recognised:

- identify contracts with customers
- identify the separate performance obligation
- determine the transaction price of the contract
- allocate the transaction price to each of the separate performance obligations
- recognise the revenue as each performance obligation is satisfied.

Key changes to current practice are:

i. 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.

ii. Revenue may be recognised earlier than under current standards if the consideration varies for any reasons (such as for incentives, rebates, performance fees, royalties, success of an outcome etc) – minimum amounts must be recognised if they are not at significant risk of reversal.

iii. 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.

iv. There are new specific rules on licenses, warranties, non-refundable upfront fees and, consignment arrangements, to name a few.

v. There are also increased disclosures.

These accounting changes may have flow-on effects on the entity's business practices regarding systems, processes and controls, compensation and bonus plans, contracts, tax planning and investor communications. Entities will have a choice of full retrospective application, or prospective application with additional disclosures.

Amendments to SLFRS 15, 'Revenue from contracts with customers': These amendments comprise clarifications of the guidance on identifying performance obligations, accounting for licences of intellectual property and the principal versus agent assessment (gross versus net revenue presentation permitted).

The standard and the amendment is effective for the annual periods beginning on or after 1 January 2018.

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2. BASIS OF PREPARATION (CONTINUED)

2.5 Changes in accounting standards (contd)

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

(iii) SLFRS 16 Leases

SLFRS 16 will affect primarily the accounting by lessees and will result in the recognition of almost all leases on balance sheet. The standard removes the current distinction between operating and financing leases and requires recognition of an asset (the right to use the leased item) and a financial liability to pay rentals for virtually all lease contracts. An optional exemption exists for short-term and low-value leases.

The income statement will also be affected because the total expense is typically higher in the earlier years of a lease and lower in later years. Additionally, operating expense will be replaced with interest and depreciation, so key metrics like EBITDA will change.

Operating cash flows will be higher as cash payments for the principal portion of the lease liability are classified within financing activities. Only the part of the payments that reflects interest can continue to be presented as operating cash flows.

The accounting by lessors will not significantly change. Some differences may arise as a result of the new guidance on the definition of a lease. Under SLFRS 16, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

The standard is effective for annual periods beginning on or after 1 January 2019 with earlier application permitted if SLFRS 15, 'Revenue from Contracts with Customers', is also applied.

(iv) Amendments to SLFRS 2 - Classification and Measurement of Share-based Payment Transactions

The amendments made to clarify the measurement basis for cash-settled share-based payments and the accounting for modifications that change an award from cash-settled to equity-settled. They also introduce an exception to the classification principles in SLFRS 2. Where an employer is obliged to withhold an amount for the employee's tax obligation associated with a share-based payment and pay that amount to the tax authority, the whole award will be treated as if it was equity-settled provided it would have been equity-settled without the net settlement feature.

Entities with the following arrangements are likely to be affected by these changes:

i. equity-settled awards that include net settlement features relating to tax obligations
ii. cash-settled share-based payments that include performance conditions, and
iii. cash-settled arrangements that are modified to equity-settled share-based payments.

The amendment is effective for the annual periods beginning on or after 1 January 2018.

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2. BASIS OF PREPARATION (CONTINUED)

2.5 Changes in accounting standards (contd)

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

(v) Amendments to LKAS 28, 'Investments in associates and joint ventures'.

LKAS 28 - clarifies that the election by venture capital organisations, mutual funds, unit trusts and similar entities to measure investments in associates or joint ventures at fair value through profit or loss should be made separately for each associate or joint venture at initial recognition.

The amendment is effective for the annual periods beginning on or after 1 January 2018.

Amendments to LKAS 28, 'Investments in associates and joint ventures', Long-term Interests in Associates and Joint Ventures : These amendments clarify that companies account for long-term interests in an associate or joint venture to which the equity method is not applied using SLFRS 9.

The amendment is effective for the annual periods beginning on or after 1 January 2019.

(vi) Amendments to LKAS 40 - Transfers of Investment Property

The amendments clarify that transfers to, or from, investment property can only be made if there has been a change in use that is supported by evidence. A change in use occurs when the property meets, or ceases to meet, the definition of investment property. A change in intention alone is not sufficient to support a transfer.

The list of evidence for a change of use in the standard was re-characterised as a non-exhaustive list of examples to help illustrate the principle.

Provided two option for transition:

- prospectively, with any impact from the reclassification recognised as adjustment to opening retained earnings as at the date of initial recognition, or
- retrospectively - only permitted without the use of hindsight.

Additional disclosures are required if an entity adopts the requirements prospectively.

The amendment is effective for the annual periods beginning on or after 1 January 2018.

(vii) IFRIC 22, 'Foreign Currency Transactions and Advance Consideration'

The interpretation clarifies how to determine the date of transaction for the exchange rate to be used on initial recognition of a related asset, expense or income where an entity pays or receives consideration in advance for foreign currency-denominated contracts.

2. BASIS OF PREPARATION (CONTINUED)

2.5 Changes in accounting standards (contd)

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

For a single payment or receipt, the date of the transaction should be the date on which the entity initially recognises the non-monetary asset or liability arising from the advance consideration (the prepayment or deferred income/contract liability).

If there are multiple payments or receipts for one item, a date of transaction should be determined as above for each payment or receipt.

Entities can choose to apply the interpretation:

- retrospectively for each period presented
- prospectively to items in scope that are initially recognised on or after the beginning of the reporting period in which the interpretation is first applied, or
- prospectively from the beginning of a prior reporting period presented as comparative information.

The amendment is effective for the annual periods beginning on or after 1 January 2018.

(viii) IFRIC 23, 'Uncertainty over income tax treatments'

This IFRIC clarifies how the recognition and measurement requirements of LKAS 12 'Income taxes', are applied where there is uncertainty over income tax treatments.

An uncertain tax treatment is any tax treatment applied by an entity where there is uncertainty over whether that treatment will be accepted by the tax authority. For example, a decision to claim a deduction for a specific expense or not to include a specific item of income in a tax return is an uncertain tax treatment if its acceptability is uncertain under tax law. IFRIC 23 applies to all aspects of income tax accounting where there is an uncertainty regarding the treatment of an item, including taxable profit or loss, the tax bases of assets and liabilities, tax losses and credits and tax rates.

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 profit or loss.

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 recognised 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.

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3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.2 Interest (contd)

Interest income and expense presented in the income statement include;

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

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 recognised 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.

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3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.4 Taxation (contd)

Deferred tax (contd)

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 utilised. 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 the 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.

3.5 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.

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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)

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 profit or loss 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.

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 certain circumstances, 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.

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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)

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 recognised 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 amortised cost using the effective interest rate method (EIR), less impairment. Amortised 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 amortisation is included in interest income in the income statement. The losses arising from impairment are recognised 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 recognised 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.

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.

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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)

Interest income on AFS financial assets is recognised 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 recognised in other comprehensive income until the investment is sold or impaired, whereupon the cumulative gains and losses previously recognised as in other comprehensive income are reclassified to profit or loss 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.

3.5.2.2 Financial liabilities

A financial liability is derecognised 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 recognised in income statement.

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Financial assets and financial liabilities (contd)

3.5.2 Derecognition (contd)

3.5.2.2 Financial liabilities (contd)

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 recognised amounts and it intends either to settle on a net basis or to realise 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 Amortised cost measurement

The amortised 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 amortisation using the effective interest method of any difference between the initial amount recognised 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.

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Financial assets and financial liabilities (contd)

3.5.5 Fair value measurement (contd)

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 prices from observable current market transactions in the same instrument or based on other available observable market data.

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 asking 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 reorganisation, 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 amortised cost

For financial assets carried at amortised 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 recognised, are not included in the 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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 amortised cost (contd)

difference between the assets'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 recognised 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 realised 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 recognised, the previously recognised 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 cash flows of a collateralised 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.

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

For available–for–sale financial investments, the Branch assesses at each reporting date whether there is objective evidence that an investment is impaired.

In the case of debt instruments classified as available–for–sale, the Branch assesses individually whether there is objective evidence of impairment based on the same criteria as financial assets carried at amortised cost. However, the amount recorded for impairment is the

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Financial assets and financial liabilities (contd)

3.5.6 Impairment of financial assets (contd)

3.5.6.2 Available-for-sale financial investments (contd)

cumulative loss measured as the difference between the amortised cost and the current fair value, less any impairment loss on that investment previously recognised 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 recognised 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 loans to 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.

3.7 Cash flow statements

The cash flow 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.

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3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 machinery are charged to the income statement. All major renovations and renewals are capitalised.

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
Personal computers and local area networks	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.

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 recognised 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 recognised in income statement.

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.9 Assets and bases of their valuation (contd)

3.9.2 Export bills negotiated and discounted

The export bills are shown in the books at their face values. Export bills in foreign currencies are mnnnconverted 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 these are 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.

3.10.1 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. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 recognised 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 recognised 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. Re-measurement 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.

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 contributes 12% 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.

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.11 Liabilities and provisions (contd)

3.11.1 Employee retirement benefit obligation (contd)

Trust fund

The Branch contributes 3% of the gross salary of employees to the Employees Trust Fund, 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.

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. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.11 Liabilities and provisions (contd)

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 recognised 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. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are addressed below.

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 the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the current and deferred income tax assets and 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.

4. SIGNIFICANT MANAGEMENT ESTIMATES AND JUDGEMENTS (CONTINUED)

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 sise 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. However, LKR Options 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.

4. SIGNIFICANT MANAGEMENT ESTIMATES AND JUDGEMENTS (CONTINUED)

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.

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.

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4. SIGNIFICANT MANAGEMENT ESTIMATES AND JUDGEMENTS (CONTINUED)

Impairment of loans and advances (contd)

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 sise 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	**2017 Rs.'000**	2016 Rs.'000
Interest income		
Other financial assets held-for-trading **(Note 5.1)**	**414,885**	262,311
Loans and receivables to banks	**111,125**	322,289
Loans and receivables to other customers	**14,751,967**	13,410,896
Financial investments - available-for-sale **(Note 5.1)**	**12,873,136**	11,642,617
Others	**294,606**	100,686
Total interest income	**28,445,719**	25,738,799
Interest expenses		
Due to banks	**(445,001)**	(137,878)
Due to other customers	**(7,843,603)**	(6,893,158)
Others	**(2,014,673)**	(1,414,992)
Total interest expenses	**(10,303,277)**	(8,446,028)
	18,142,442	17,292,771

5.1 Net interest income from Sri Lanka Government Securities		
Interest income	**13,288,021**	11,904,928

6 Net fee and commission income	**2017 Rs.'000**	2016 Rs.'000
Fee and commission income	**3,680,452**	3,484,406
Fee and commission expenses	**(882,970)**	(632,242)
	2,797,482	2,852,164

6.1 Comprising		
Loans	**215,994**	82,487
Credit cards	**1,418,833**	1,590,622
Trade and remittances	**1,010,107**	1,043,045
Deposits	**110,541**	136,668
Trustee and fiduciary	**190,761**	184,414
Others	**(148,754)**	(185,072)
Net fee and commission income	**2,797,482**	2,852,164

7 Net gain from trading	**2017 Rs.'000**	2016 Rs.'000
Foreign exchange (excluding derivatives)		
- Gain from transaction with customers	**2,571,587**	2,410,057
- Loss from transactions with others	**(963,406)**	(365,637)
Government securities	**279,010**	178,254
Gains / (losses) from derivatives	**2,001**	(77,588)
	1,889,192	2,145,086

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FOR THE YEAR ENDED 31 DECEMBER

		2017	2016
8	**Net gain / (loss) from financial investments**	**Rs.'000**	Rs.'000
	Net gain from financial investments	**307,951**	(5,910)
		307,951	**(5,910)**

		2017	2016
9	**Other operating income (net)**	**Rs.'000**	Rs.'000
	Profit on sale of property, plant and equipment	**25,935**	16,879
	Others	**25,648**	32,796
		51,583	49,675

		2017	2016
10	**Impairment charges for loans and other losses**	**Rs.'000**	Rs.'000
	Individual significant impairment charge **(Note 10.1)**	**(22,165)**	(89,112)
	Collective impairment charge **(Note 10.2)**	**(226,398)**	(112,866)
		(248,563)	(201,978)
10.1	**Individual impairment charge**		
	Impairment reversal /(provision) for the year		
	- For customer balances	**377,213**	(124,234)
	Direct write-offs for the year	**(425,981)**	(15,183)
	Recoveries during the year	**26,603**	50,305
		(22,165)	(89,112)
10.2	**Collective impairment charge**		
	Impairment reversal for the year	**26,525**	51,752
	Direct write-offs for the year	**(617,439)**	(634,814)
	Recoveries during the year	**364,516**	470,196
		(226,398)	(112,866)

		2017	2016
11	**Personnel expenses**	**Rs.'000**	Rs.'000
	Salary and bonus	**(2,375,155)**	(2,325,590)
	Others	**(1,117,148)**	(921,756)
		(3,492,303)	(3,247,346)

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12 Other expenses	2017 Rs.'000	2016 Rs.'000
Auditors' remunerations	**(2,802)**	(2,249)
Non-audit fees to auditors	**(1,162)**	(8,857)
Professional and legal expenses	**(30,708)**	(61,888)
Depreciation of property, plant and equipment	**(304,936)**	(337,479)
Office administration and establishment expenses	**(2,215,548)**	(2,215,743)
Others	**(4,251,318)**	(3,931,959)
	(6,806,474)	(6,558,175)

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

13 Tax expense	2017 Rs.'000	2016 Rs.'000
13.a Current tax expense		
Current tax on profit for the year **(Note 13.c)**	**(4,062,178)**	(3,822,650)
Over provision for the previous year	**(1,945)**	(40,840)
Tax of prior years paid in current year	-	(13,095)
Remittance tax	**(227,086)**	(164,261)
	(4,291,209)	(4,040,846)
13.b Deferred tax expenses		
- Provision for employee benefit	-	(3,012)
- Owned assets	**(16,234)**	-
- Allowance for loans losses	-	(6,908)
Deferred tax assets reversed during the year	**(16,234)**	(9,920)
- Provision for employee benefit	**518**	-
- Depreciation on revaluation of land & building	**1,433**	8,262
- Allowance for loans losses	**4,518**	16,712
Deferred tax liabilities recognized during the year	**6,469**	24,974
	(9,765)	15,054
Total tax charge to income statement	**(4,300,974)**	(4,025,792)
13.c Reconciliation between tax expense and accounting profit		
Accounting profit before taxation	**10,709,008**	10,636,709
Add: disallowable items	**7,842,257**	6,871,305
Less: allowable items	**(2,070,740)**	(1,989,832)
Exempted income	**(1,972,742)**	(1,865,860)
Taxable income	**14,507,783**	13,652,322
Income tax @ 28%	**(4,062,178)**	(3,822,650)
13.d Tax charge to the statement of other comprehensive income		
-Provision for employee benefit	**71,793**	6,772
-AFS reserve	**(676,692)**	197,149
-Revaluation of buildings	**(36,678)**	(34,019)
	(641,577)	169,902

AS AT 31 DECEMBER

14 Analysis of financial instruments by measurement basis

14.1 As at 31 December 2017

	Held for trading Rs.'000	Amortized cost Rs.'000	Available for sale Rs.'000	Total Rs.'000
ASSETS				
Cash and cash equivalents	-	7,721,011	-	7,721,011
Balances with Central Bank	-	7,765,246	-	7,765,246
Placements with banks	-	41,214,750	-	41,214,750
Derivative financial instruments	1,265,432	-	-	1,265,432
Financial assets held for trading	4,762,430	-	-	4,762,430
Loans and receivables from other customers	-	202,739,049	-	202,739,049
Financial investments	-	-	150,869,348	150,869,348
Acceptances and endorsements	-	6,239,553	-	6,239,553
Total financial assets	**6,027,862**	**265,679,609**	**150,869,348**	**422,576,819**
LIABILITIES				
Due to banks	-	175,400,730	-	175,400,730
Derivative financial instruments	1,032,710	-	-	1,032,710
Due to other customers	-	180,725,041	-	180,725,041
Acceptances and endorsements	-	6,239,553	-	6,239,553
Total financial liabilities	**1,032,710**	**362,365,324**	**-**	**363,398,034**

14.2 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 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**

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15 Cash and cash equivalents

	2017 Rs.'000	2016 Rs.'000
Cash in hand	**1,287,738**	1,184,525
Balances with other banks	**6,433,273**	6,203,784
	7,721,011	7,388,309

16 Balances with the Central Bank of Sri Lanka

	2017 Rs.'000	2016 Rs.'000
Balances with Central Bank	**7,765,246**	9,090,026
	7,765,246	9,090,026

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 2017 (2016 : 7.5%).

17 Placements with banks

	2017 Rs.'000	2016 Rs.'000
Placements	**41,214,750**	40,524,300
	41,214,750	40,524,300

18 Derivative financial instruments

	2017 Rs.'000	2016 Rs.'000
Interest rate derivatives		
Interest rate swaps	**35,901**	73,889
Currency options	-	162
Forward foreign exchange contracts	**1,229,531**	397,706
	1,265,432	471,757

19 Other financial assets held-for-trading

	2017 Rs.'000	2016 Rs.'000
Treasury bills	**277,771**	-
Treasury bonds	**4,484,659**	756,106
	4,762,430	756,106

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20 Loans and receivables from banks	2017 Rs.'000	2016 Rs.'000
Gross loans and receivables (Note 20.1)	-	-
	-	-

20.1 Analysis

a. By product		
Short-term loans	-	-
Reverse repo agreements	-	-
Gross Total	-	-
b. By currency		
Sri Lankan Rupee	-	-
United States Dollar	-	-
Gross Total	-	-

21 Loans and receivables from other customers	2017 Rs.'000	2016 Rs.'000
Gross loans and receivables (Note 21.1)	203,505,562	213,996,134
Less: Provision for impairment loss (Note 21.2)	(766,513)	(1,121,050)
Net loans and receivables	202,739,049	212,875,084

21.1 Analysis

a. By product		
Overdrafts	16,932,499	16,737,168
Trade finance	38,269,262	34,672,361
Credit cards	21,266,957	20,521,991
Staff loans	1,836,986	2,104,415
Term loans - short term	16,168,700	17,223,539
Term loans - long term	107,995,151	121,702,319
Mortgages	1,036,007	1,034,341
Gross Total	203,505,562	213,996,134
b. By currency		
Sri Lankan Rupee	66,607,542	64,246,656
United States Dollar	129,413,712	141,817,921
Great Britain Pound	17,521	411,211
Others	7,466,787	7,520,346
Gross Total	203,505,562	213,996,134
c. By industry		
Agriculture and fishing	8,818,473	8,947,102
Manufacturing	52,771,003	49,218,345
Tourism	32,001,371	29,036,938
Transport	6,741,996	14,636,098
Construction	4,083,982	5,102,524
Traders	25,559,244	29,182,741
New economy	15,198,806	19,071,795
Others	58,330,687	58,800,591
Gross Total	203,505,562	213,996,134

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21.2 Provision for impairment loss	2017 Rs.'000	2016 Rs.'000
a. Individual impairment charges		
Opening balance	727,608	698,755
(Reversal) / charge for the year	(377,213)	124,234
Exchange fluctuations and other movements	6,541	(95,381)
Closing balance	356,936	727,608
b. Collective impairment charges		
Opening balance	393,442	333,757
Reversal for the year	(26,525)	(51,752)
Exchange fluctuations and other movements	42,660	111,437
Closing balance	409,577	393,442
Total	766,513	1,121,050

22 Financial investments – available-for-sale	2017 Rs.'000	2016 Rs.'000
Treasury bills	5,570,425	6,162,641
Treasury bonds	145,298,923	116,351,934
	150,869,348	122,514,575

22.1 Securities pledged against repurchase agreements		
Repo value	227,989	207,438
Fair value of securities held	229,957	209,533

As of the financial year 2017, there were nil reverse repurchase agreements transactions.

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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 2016	1,698,000	1,277,000	775,097	17,316	186,225	580,125	268,835	-	4,802,598
Additions during the year	-	80,630	71,472	931	1,517	65,961	18,900	-	239,411
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	1,348,379	735,263	16,681	178,801	644,717	222,220	-	4,920,208
Balance as at 1 January 2017	**1,774,147**	**1,348,379**	**735,263**	**16,681**	**178,801**	**644,717**	**222,220**	**-**	**4,920,208**
Additions during the year	**-**	**-**	**20,954**	**611**	**4,018**	**27,255**	**-**	**-**	**52,838**
Disposals during the year	**-**	**-**	**(2,021)**	**(385)**	**(2,002)**	**(5,889)**	**(57,976)**	**-**	**(68,273)**
Transfers during the year	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Revaluation gain	**331,486**	**19,737**	**-**	**-**	**-**	**-**	**-**	**-**	**351,223**
Balance as at 31 December 2017	**2,105,633**	**1,368,116**	**754,196**	**16,907**	**180,817**	**666,083**	**164,244**	**-**	**5,255,996**
Accumulated depreciation									
Balance as at 1 January 2016	-	-	413,948	16,925	162,452	360,685	203,689	-	1,157,699
Charge for the year	-	128,290	78,486	223	7,572	82,999	39,838	-	337,408
Disposals during the year	-	5	(110,992)	(1,452)	(8,612)	(1,200)	(61,730)	-	(183,981)
Reclassified during the year	-	-	(28)	-	(27)	55	-	-	-
Revaluation adjustment	-	(128,295)	-	-	-	-	-	-	(128,295)
Balance as at 31 December 2016	-	-	381,414	15,696	161,385	442,539	181,797	-	1,182,831
Balance as at 1 January 2017	**-**	**-**	**381,414**	**15,696**	**161,385**	**442,539**	**181,797**	**-**	**1,182,831**
Charge for the year	**-**	**111,259**	**93,795**	**296**	**6,099**	**70,073**	**23,414**	**-**	**304,936**
Reclassified during the year	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Revaluation adjustment	**-**	**(111,259)**	**-**	**-**	**-**	**-**	**-**	**-**	**(111,259)**
Disposals during the year	**-**	**-**	**(2,022)**	**(385)**	**(1,977)**	**(5,107)**	**(51,764)**	**-**	**(61,255)**
Balance as at 31 December 2017	**-**	**-**	**473,187**	**15,607**	**165,507**	**507,505**	**153,447**	**-**	**1,315,253**
Carrying value									
As at 31 December 2016	1,774,147	1,348,379	353,849	985	17,416	202,178	40,423	-	3,737,377
As at 31 December 2017	**2,105,633**	**1,368,116**	**281,009**	**1,300**	**15,310**	**158,578**	**10,797**	**-**	**3,940,743**

a) As at 31 December 2017, property plant and equipment include fully depreciated assets of amounting to Rs 906,425,880 (2016 - 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	
	2017	**2016**	**2017**	**2016**
	Rs.	**Rs.**	**Rs.**	**Rs.**
Cost	4,970,000	4,970,000	1,092,427,363	1,092,427,363
Accumulated depreciation	-	-	(290,304,254)	(193,970,991)
Net book amount as at 31 December	**4,970,000**	**4,970,000**	**802,123,109**	**898,456,372**

23 Property, plant and equipment (contd)

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

The land and buildings of the Branch as at 31 December 2017 have been revalued and the revalued amounts have been incorporated in the financial statements for the year. This is considered as a level 3 valuation and the details of the valuation are given below.

Property	Name and Qualifications of the valuer	Valuation Technique	Significant unobservable inputs	Inter-relationship between key unobservable inputs and fair value measurement
Sir Baron Jayatilaka Mawatha, Colombo 01	1. Ashwin Thenappan MBA Finance 4 years experience 2. Anuradha Vijay M.Arch 12 years experience 3. Somy Thomas MBA 14 years experience	Summation approach of "Income capitalisation" and "Depreciated Replacement Cost" approach	Rate per square foot	Direct correlation - higer the rate per square foot, higher the market value
Independence Avenue, Colombo 07	1. Ashwin Thenappan MBA Finance 4 years experience 2. Anuradha Vijay M.Arch 12 years experience 3. Somy Thomas MBA 14 years experience	Land Sales Comparable Method plus Cost Spent approach	The property is under construction and therefore cost spent has been considered	Direct correlation - higer the cost spent, higher the market value

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24 Deferred tax (liabilities) / assets

	2017 Rs.'000	2016 Rs.'000
Deferred tax assets	**354,973**	673,566
Deferred tax liabilities	**(461,244)**	(128,493)
	(106,271)	545,073

24.1 Reconciliation of deferred tax

Deferred tax assets and liabilities are attributable to the following:

	2017		2016	
	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
Provision for retirement benefit obligation	**858,185**	**240,292**	599,933	167,981
Allowance for loan losses	**409,578**	**114,681**	393,443	110,164
Available for sale reserve	-	-	1,383,918	387,497
	1,267,763	**354,973**	2,405,593	673,566
Deferred tax liabilities on ;				
Revaluation of buildings	**(584,779)**	**(163,738)**	(458,902)	(128,493)
Accelerated depreciation for tax	**(29,681)**	**(8,311)**	-	-
Available for sale reserve	**(1,032,840)**	**(289,195)**	-	-
	(1,647,300)	**(461,244)**	(458,902)	(128,493)
Net (liabilities) / assets as at 31 December	**(379,537)**	**(106,271)**	1,946,691	545,073

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

25 Other assets

	2017 Rs.'000	2016 Rs.'000
Receivables	**4,374,967**	3,560,334
Deposits and prepayments	**375,061**	538,116
Acceptances and endorsements	**6,239,553**	6,506,718
Others	**3,638,021**	2,794,898
	14,627,602	13,400,066

26 Due to banks

	2017 Rs.'000	2016 Rs.'000
Borrowings	**166,455,097**	146,598,269
Others	**8,945,633**	4,986,865
	175,400,730	151,585,134

27 Derivative financial instruments

	2017 Rs.'000	2016 Rs.'000
Currency options	-	-
Interest rate derivatives	**35,893**	74,713
Forward foreign exchange contracts	**996,817**	308,759
	1,032,710	383,472

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28 Due to other customers	2017 Rs.'000	2016 Rs.'000
Total amount due to other customers (Note 28.1)	180,725,041	183,343,212
	180,725,041	183,343,212

28.1 Analysis		
a. By product		
Demand deposits (current accounts)	41,716,995	39,534,056
Savings deposits	41,530,878	44,223,825
Fixed deposits	92,649,756	95,583,529
Other deposits	4,827,412	4,001,802
Total	180,725,041	183,343,212
b. By currency		
Sri Lankan Rupees	111,311,044	113,880,895
United States Dollar	53,700,387	52,711,790
Great Britain Pound	6,051,823	6,254,051
Others	9,661,787	10,496,476
Total	180,725,041	183,343,212

29 Other liabilities	2017 Rs.'000	2016 Rs.'000
Sundry creditors	499,691	572,653
Interest payable	4,885,657	7,749,764
Acceptances and endorsements	6,239,553	6,506,718
Defined benefit liability - net (Note 29.1)	125,358	(10,787)
Other payables	7,119,852	5,208,692
	18,870,111	20,027,040

	2017 Rs.'000	2016 Rs.'000
29.1 Defined benefit liability - net		
Present value of defined benefit obligations (Note 29.1.a)	858,185	599,933
Fair value of plan assets (Note 29.1.b)	(732,827)	(610,719)
	125,358	(10,786)
29.1.a Movement in the present value of defined benefit obligations		
Opening balance	599,933	586,505
Current service cost	2,188	2,417
Interest cost	74,905	72,746
Benefits paid during the year	(75,243)	(85,919)
Actuarial gain or loss for the year	256,402	24,184
Closing balance	858,185	599,933
29.1.b Movement in fair value of plan assets		
Opening balance	610,719	567,367
Expected return on plan assets	75,695	71,475
Contribution by employers	84,000	84,000
Benefits paid during the year	(75,243)	(85,919)
Actuarial gain or loss for the year	37,656	(26,204)
Closing balance	732,827	610,719

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29.1.c Sensitivity analysis of the defined benefit obligation

	2017 Rs.'000	2016 Rs.'000
a. Discount rate		
Discount rate	**10.40%**	13.30%
1. Effect due to the increase in the discount rate by 1.00% (Rs '000)	**(75,719)**	(37,319)
1. Effect due to the decrease in the discount rate by 1.00% (Rs '000)	**92,258**	42,833
b. Increase in salary escalation rate and post retirement pension		
Salary escalation rate		
- Union members	**10%**	10%
- Non-union members	**5%**	3%
Post retirement pension	**3.1%**	3.1%
1. Effect on DBO due to an increase in the salary escalation and post retirement pension rate by 1% p.a. (Rs '000)	**79,257**	40,765
2. Effect on DBO due to a decrease in the salary escalation and post retirement pension rate by 1% p.a. (Rs '000)	**(68,608)**	(36,488)

30 Assigned capital

	2017 Rs.'000	2016 Rs.'000
Assigned Capital	**3,152,358**	3,152,358
	3,152,358	3,152,358

31 Statutory reserve fund

	2017 Rs.'000	2016 Rs.'000
Opening balance	**2,222,693**	2,090,476
Transferred during the year	**128,162**	132,218
Closing balance	**2,350,855**	2,222,693

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

	2017 Rs.'000	2016 Rs.'000
Exchange equalisation of reserve **(Note 32.1)**	**5,629,182**	5,002,336
Available for sale reserve **(Note 32.2)**	**743,645**	(988,971)
Revaluation reserve **(Note 32.3)**	**2,521,649**	2,099,530
IFA reserve **(Note 32.4)**	**5,108,459**	5,108,459
SBP reserve **(Note 32.5)**	**168,234**	171,369
	14,171,170	11,392,723

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32 Other reserves (Continued)

32.1 Exchange equalisation of reserve

	2017 Rs.'000	2016 Rs.'000
Opening balance	**5,002,336**	4,039,608
Fluctuation of foreign exchange reserves	**626,846**	962,728
Closing balance	**5,629,182**	5,002,336

32.2 Available for sale reserve

	2017 Rs.'000	2016 Rs.'000
Opening balance	**(988,971)**	(489,466)
Net gain on revaluation	**1,732,616**	(499,505)
Closing balance	**743,645**	(988,971)

32.3 Revaluation reserve

	2017 Rs.'000	2016 Rs.'000
Opening balance	**2,099,530**	1,957,210
Revaluation surplus for the year	**422,119**	142,319
Closing balance	**2,521,649**	2,099,530

32.4 IFA reserve

	2017 Rs.'000	2016 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 Investment Fund Account. Operations of IFA ceased with effect from 1 October 2014 and the above indicates the balance accrued up to that date.

32.5 Share based payment reserve

	2017 Rs.'000	2016 Rs.'000
Opening balance	**171,369**	172,198
Transferred during the year	**(3,135)**	(829)
Closing balance	**168,234**	171,369

HSBC Sri Lanka has a share option plan referred to as "HSBC Restricted Shares". Under this share option plan, HSBC Group defers part of the annual discretionary variable pay of a few senior managers into shares according to a vesting schedule. The shares are granted to the employees within a span of three years' vesting period. The cost of the shares are initially borne by the HSBC Group Head Office in UK and subsequently recharged to the local office (i.e. in the case of Sri Lankan employees, HSBC UK recharges the cost from HSBC Sri Lanka).

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		2017	2016
32.6	**Share based payments and share option**		
32.6.1	**Restricted share awards - No of shares**		
	Outstanding at the beginning	**27,922**	23,395
	Awards during the year	**18,903**	15,445
	Vested during the year	**(13,140)**	(10,918)
	Outstanding at the end	**33,685**	27,922

		Rs.'000	Rs.'000
32.6.2	**Share-based payments income statement charge**		
	Restricted and performance share awards	**19,780**	13,758
	Share award option plans	**(410)**	367
		19,370	14,125

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.

	2017 Rs.'000	2016 Rs.'000
Performance bonds	**6,136,407**	5,054,268
Letters of credit	**8,012,482**	10,339,782
Other contingent items	**46,175,651**	24,951,047
Undrawn loan commitments	**181,836,466**	178,224,346
Foreign exchange contracts	**251,218,496**	205,244,944
Derivatives- principal amount	**21,885,007**	99,979,449
Other contra accounts	**17,999,797**	16,397,769
Total	**533,264,306**	540,191,605

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35 Commitments and contingencies (contd)

b. Pending litigations against the Branch as at 31 December 2017

1. Case no. DMR 02342/16 filed in District Court of Colombo where the plaintiff 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.

2. Court action has been initiated by 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.

3. Five Labour Tribunal actions have been taken under case numbers 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.

4. 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.

5. 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 Branch has been enlisted as the 4th defendant for giving evidence on certain transactions of the plaintiff.

6 Plaintiff is suing the Branch for breach of duty of care and for acting negligently under court proceeding (Case No. DMR/2275/2012)

7. Law suit instituted by a former staff (Plaintiff) 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.

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

9. Testamentary case DTS 00288 / 2016, has been instituted over the estate of a deceased customer of the Bank. The Bank has been made a party in order to obtain a court order to continue to hold the fixed deposit's of the deceased and to settle the OD from the interest earned from the fixed deposits until the case is concluded.

10. Case No: DMR 00285/17, has been instituted by the plaintiff filing action against the first defendant, who has credited 12 cheques, drawn in favour of the plaintiff or Bearer, into his personal account with HSBC and also joined HSBC as the second defendant on grounds of negligence and breach of duty of care.

11. The Honourable Minister of Labour has referred two disputes pertaining to the payment of Pension for two former staff, which is currently pending with the Commissioner of Labour , for compulsory Arbitration.

There are no material contingent liabilities outstanding as at the reporting date other than those disclosed above which would require adjustments to or disclosure in financial statements.

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36 Related party disclosures

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

	2017 Rs.'000	2016 Rs.'000
Other HSBC Branches		
HSBC Hongkong	2,003,716	1,506,049
	2,003,716	1,506,049
Group companies		
HSBC London	-	44
HSBC Australia	-	151
HSBC Data Processing Ltd	10,957	10,420
HSBC Middle East	-	92
	10,957	10,707

(b) Interest received from other HSBC Branches and Group companies

	2017 Rs.'000	2016 Rs.'000
Other HSBC Branches		
HSBC Hongkong	294,624	100,508
	294,624	100,508
Group companies		
HSBC London	-	33
HSBC China	-	16
HSBC Data Processing Ltd	13	129
	13	178

(c) Commission paid to other HSBC Branches and Group companies

	2017 Rs.'000	2016 Rs.'000
Other HSBC Branches		
HSBC Hongkong	40,861	39,125
HSBC New Zealand	157	148
HSBC Japan	93	213
HSBC Singapore	226	279
HSBC India	14	-
HSBC Thailand	192	148
HSBC Malaysia	11	14
	41,554	39,927
Group companies		
HSBC London	174	120
HSBC Canada	577	549
HSBC Australia	1,307	1,421
HSBC USA	40,219	20,592
HSBC Trinkaus and Burkhardt	644	823
HSBC United Arab Emirates	5	13
	42,926	23,518

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36. Related Party Disclosures (contd)

36.1 Transactions with related parties (contd)

(d) Assets of other HSBC Branches and Group companies	**2017 Rs.'000**	2016 Rs.'000
Other HSBC Branches		
HSBC Hongkong	**41,519,361**	41,102,923
HSBC New Zealand	**259,296**	87,656
HSBC Japan	**44,880**	56,543
HSBC Singapore	**55,023**	44,931
HSBC India	**1,617,299**	611,874
HSBC Thailand	**838**	990
HSBC Maldives	**24,031**	195,437
	43,520,728	42,100,354
Group companies		
HSBC London	**1,296,388**	1,046,300
HSBC China (Bank) Co. Ltd	**1,152**	609
HSBC Canada	**22,561**	84,317
HSBC USA	**2,503,184**	3,162,835
HSBC Data processing Ltd	**658**	-
HSBC UAE	**4,109**	5,591
HSBC Australia	**59,656**	123,614
	3,887,708	4,423,266

(e) Liabilities of other HSBC Branches and Group companies	**2017 Rs.'000**	2016 Rs.'000
Other HSBC Branches		
HSBC Hongkong (Branch)	**153,316,972**	147,064,385
HSBC Hongkong (Head Office)	**202,369**	-
HSBC New Zealand	**-**	-
HSBC Japan	**6,168**	618
HSBC Singapore	**7,310**	403
HSBC India	**403,791**	114,632
HSBC Bangladesh	**249,859**	304,718
HSBC Maldives	**350**	2,676
	154,186,819	147,487,432
Group companies		
HSBC London	**426,995**	928,823
HSBC Trustee (Hong Kong) Ltd	**70**	-
HSBC Baharain	**580**	840
HSBC Canada	**64**	12
HSBC China (Bank) Co. Ltd	**4,527**	4,672
HSBC USA	**518,888**	1,297,659
HSBC Securities (New York)	**5,596**	-
HSBC Data processing Ltd - Sri Lanka	**1,457,973**	1,700,154
HSBC Data processing Ltd - India	**10,445**	-
HSBC Bank Malaysia Berhad	**1,213**	966
HSBC Bank (Singapore) Limited	**21,242**	10,316
HSBC Kuwait	**436**	436
HSBC France	**41**	-
HSBC Qatar	**484**	2,584
HSBC Vietnam	**59**	-
HSBC Trinkaus & Burkhardt	**21**	-
HSBC UAE	**3,811**	6,606
HSBC Australia	**4,783**	9,680
	2,457,228	3,962,748

36 Related party disclosure (contd)

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, Head of Regulatory Compliance, Director /Head of Global Markets, General Legal Counsel, Head of Information Technology, Head of Wholesale 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	2017 Rs.'000	2016 Rs.'000
Aggregate remuneration paid for the year	**251,609**	334,294
	251,609	334,294

36.2.b Transactions with KMPs and their close relations	2017 Rs.'000	2016 Rs.'000
Total deposits	**72,371**	129,800
Total accommodation granted	**270,310**	267,551
	342,681	397,351

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	2,129,421	7,507,276	12,344,168	959,222	22,940,087
Operating expenses	(6,075,213)	(2,635,210)	(1,321,676)	(266,678)	(10,298,777)
(Loss) / profit before tax	(7,090,054)	4,929,920	12,176,798	692,344	10,709,008
Income tax expense	1,736,640	(1,217,184)	(4,515,588)	(304,842)	(4,300,974)
(Loss) / profit after tax	**(5,353,414)**	**3,712,736**	**7,661,210**	**387,502**	**6,408,034**
Segment assets	**45,636,979**	**159,298,115**	**201,916,594**	**28,053,923**	**434,905,611**
Segment liabilities	**114,727,778**	**75,179,311**	**181,857,700**	**63,140,822**	**434,905,611**

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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 balances have not changed since 31 December 2016.

(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 2017, 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		

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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.

Risk appetite and tolerance limits for key types of risks

Bank's risk appetite defines its desired forward-looking risk profile, and informs the strategic and financial planning process. Furthermore, it is integrated with other key risk management tools, such as stress testing and our top and emerging risk reports, to help ensure consistency in risk management practices. The bank sets out the aggregated level and risk types it accepts in order to achieve its business objectives in a risk appetite statement ('RAS'). This is reviewed on an ongoing basis, and formally approved by Risk Management Committee every six months and regional Risk Appetite and Governance team provides oversight. The bank's actual performance is reported monthly against the approved RAS to the RMM, enabling senior management to monitor the risk profile and guide business activity to balance risk and return. This reporting allows risks to be promptly identified and mitigated, and drive a strong risk culture. Risk Appetite and tolerance thresholds are decided by respective risk stewards in collaboration with respective business lines.

Stress testing

Enterprise Wide Stress Testing ("EWST") evaluates the potential vulnerabilities in the Bank's overall profitability, asset portfolio, liquidity, operations and capital strength under remote, yet plausible, stressed environments by assessing a variety of risks that the Bank is exposed to. Equally, it assists in the formulation of possible mitigating actions that could be considered in such circumstances.

The EWST is one of the requested stress tests in guideline for commercial banks. The EWST is developed on the basis of local regulatory reporting requirements. Local capital rules, provision rules, and financial reporting rules are followed and it is an integral part of the bank's annual ICAAP submission.

Stress tests that can be applied to a bank are broadly in two categories: sensitivity tests and scenario tests. HSBC Sri Lanka follows scenario based methodologies to assess the impact of various risks on bank's capital. Scenario tests include simultaneous moves in a number of variables based on a single event experienced in the past or a plausible market event that has not yet happened and the assessment of their impact on the bank's financial position.

HSBC Sri Lanka perform EWST under three stress scenarios with ascending levels of severity, i.e minor, medium and major, with reference to the normal situation. Accordingly we have used Global slow-down (severe crisis), (Moderate scenario) and Mild Scenario which is developed by applying shocks to Annual Operating Plan assumptions.

39 Financial risk management (contd)

39.1 Risk management framework (contd)

The EWST exercise covers Wholesale Credit Risk (including concentration risk), Retail Credit Risk, Traded Credit Risk & Market Risk and Funding Risk (including IRRBB) and Operational Risk (including compliance risk).

Stress test results are reviewed by both local and regional subject matter experts before presenting for CFO and CRO approval. Subsequently, CFO and CRO present the EWST results to the Regional team seeking their approval. As the final step, Sri Lanka HSBC EWST gross results are shared with local Risk Management Committee.

Internal stress tests are used in our enterprise-wide risk management and capital management frameworks. Risks to our capital plan are assessed through a range of scenarios which explore risks that management needs to consider under stress. They include potential adverse macroeconomic, geopolitical and operational risk events, and potential events that are specific to HSBC. Stress testing analysis helps management understand the nature and extent of any vulnerability. Using this information, management decides whether risks can or should be mitigated through management actions or, if they were to crystallise, should be absorbed through capital. This in turn informs decisions about preferred capital levels.

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 to the Branch of the contract 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 an account is classified as default or when the Branch no longer expect to recover the principal or 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 present 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.

A 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.

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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 once it's in non-performing loan status for 60 months. The process is done manually and any exception is tracked completed the next day. However early write off could be triggered by the circumstance of the account for example on death, bankruptcy, early settlement etc.

Usually Collections/Recovery activities may continue 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. Some of the collateral types that are used in order to mitigate credit risk of the Wholesale segment includes deposits under lien, property mortgages, machinery mortgages and Corporate and Bank guarantees. The main types of guarantees are the parental corporate guarantees issued by a parent company on behalf of a subsidiary, where the creditworthiness of the corporate guarantee is assessed based on the financial strength of the parent company. Guarantees issued by a third party to secure borrowings of a company is also accepted , however is not common and will be accommodated only on an exceptional basis post establishing the financial strength of the guarantor.

The secured facilities extended to retail customers consist of Home Loans, Vehicle Loans (at present both of these products are limited only to Bank's staff), facilities against shares and cash back facilities. Accordingly the nature of collateral relating to Retail facilities consist of property, vehicles, shares (Colombo Stock Exchange) and cash for respective facilities.

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

	Gross exposure 2017 Rs.000	Average gross exposure 2017 Rs.000	Gross exposure 2016 Rs.000	Average gross exposure 2016 Rs.000
By product - local currency				
Overdrafts	**12,627,843**	**14,647,990**	12,026,830	12,003,113
Term loans	**32,691,908**	**31,526,922**	31,369,946	31,296,795
Credit cards	**21,266,957**	**20,647,741**	20,521,991	19,582,770
Other loans	**20,834**	**51,990**	327,888	114,299
Sub total	**66,607,542**	**66,874,643**	64,246,655	62,996,976
By product - foreign currency				
Overdrafts	**4,304,702**	**4,847,997**	4,710,339	3,683,070
Term loans	**131,552,074**	**133,369,747**	143,739,065	134,288,782
Other loans	**1,041,245**	**948,233**	1,300,075	1,740,825
Sub total	**136,898,021**	**139,165,977**	149,749,479	139,712,677
Total	**203,505,562**	**206,040,619**	213,996,134	202,709,653

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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

	2017 Rs.000	2016 Rs.000
By product - currency		
Sri Lankan Rupee	**66,607,542**	64,246,656
United States Dollar	**129,413,712**	141,817,921
Great Britain Pound	**17,521**	411,211
Others	**7,466,787**	7,520,347
Total	**203,505,562**	213,996,134

Individual impairment - sector wise analysis

	2017 Rs.000	2016 Rs.000
By product - local currency		
Manufacturing	**260,356**	623,007
Traders	**17,465**	14,445
Transport	**6,579**	1,801
Construction	**-**	-
Financial and business services	**36,072**	51,726
Tourism	**6,421**	-
Others	**30,043**	36,629
Total	**356,936**	727,608

Collective impairment - counterparty wise analysis

	2017 Rs.000	2016 Rs.000
By product - local currency		
Retail	**319,020**	238,623
Corporate	**90,558**	154,820
	409,577	393,442

Individual impairment charge/(reversal) during the year - counterparty wise analysis

	2017 Rs.000	2016 Rs.000
By product - local currency		
Personal - mortgages	**14,401**	22,072
Personal - other loans	**2,759**	25
Corporate	**(394,373)**	102,137
	(377,213)	124,234

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
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	2017 Total Rs. 000	2016 Total Rs. 000
Agriculture & Fishing	-	350,276	1,742,544	-	-	6,725,653	-	**8,818,473**	8,947,102
Manufacturing	1,822,836	17,985,793	3,956,274	-	7,855,947	21,150,153	-	**52,771,003**	49,218,345
Tourism	-	-	1,147,607	-	-	30,853,764	-	**32,001,371**	29,036,938
Transport	1,744	-	156,978	-	4,368,865	2,214,409	-	**6,741,996**	14,636,098
Construction	-	-	147,579	-	-	1,971,379	1,965,024	**4,083,982**	5,102,524
Traders	18,062,902	37,587	2,044,468	-	2,023,429	3,390,858	-	**25,559,244**	29,182,741
New Economy	-	-	247,259	-	914,741	14,036,807	-	**15,198,807**	19,071,795
Financial and Business Services	-	-	1,011,829	-	818,011	981,945	-	**2,811,785**	8,509,492
Infrastructure	-	-	6,595	-	-	-	-	**6,595**	-
Other Services	8,125	-	1,935,119	-	187,771	10,251,010	-	**12,382,025**	8,767,393
Credit card	-	-	-	21,266,957	-	-	-	**21,266,957**	20,521,991
Other	-	-	4,536,141	-	-	17,327,183	-	**21,863,324**	21,001,715
Total	**19,895,607**	**18,373,656**	**16,932,393**	**21,266,957**	**16,168,764**	**108,903,161**	**1,965,024**	**203,505,562**	213,996,134

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
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	2017 Total Rs. 000	2016 Total Rs. 000
Overdratfs	16,932,545	-	-	-	-	-	-	-	**16,932,545**	16,737,169
Term lending	4,449,925	16,554,659	30,896,909	9,029,324	4,474,683	42,780,385	42,926,164	8,461,231	**159,573,280**	168,556,254
Non-eligible bills	485,424	236,268	340,387	-	-	-	-	-	**1,062,079**	1,627,963
Money market placements	2,001,750	254,142	27,000	-	-	-	-	-	**2,282,892**	4,027,142
Credit card advanc	21,266,957	-	-	-	-	-	-	-	**21,266,957**	20,521,991
Mortgages	482,197	77	11,183	4,080	7,082	59,807	138,072	1,685,312	**2,387,810**	2,525,615
Total gross loans and receivables	**45,618,798**	**17,045,146**	**31,275,479**	**9,033,404**	**4,481,765**	**42,840,192**	**43,064,236**	**10,146,543**	**203,505,562**	213,996,134
Acceptances	610,964	1,954,634	2,038,995	989,632	417,981	227,347	-	-	**6,239,553**	6,506,718
Total	**46,229,762**	**18,999,780**	**33,314,474**	**10,023,036**	**4,899,746**	**43,067,539**	**43,064,236**	**10,146,543**	**209,745,115**	220,502,852

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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 of past due nor impaired and impaired loans

Sector	Past due but not impaired		Impaired	
	2017 Total Rs. 000	2016 Total Rs. 000	**2017 Total Rs. 000**	2016 Total Rs. 000
Agriculture and fishing	-	-	-	-
Manufacturing	**1,743,381**	2,101,447	**273,018**	739,349
Tourism	**8,225,772**	1,598,501	**216,431**	-
Transport	-	-	**12,132**	316,023
Construction	-	600,360	-	-
Traders	**400,250**	612,531	**37,424**	33,959
New economy	**71,166**	212,008	**2,922**	5,061
Financial and business services	-	-	**80,843**	63,121
Infrastructure	-	-	-	-
Other services	**145,571**	-	-	-
Credit card	-	-	-	-
Other	**1,005,624**	1,705,851	**1,139,494**	1,102,349
Total	**11,591,763**	6,830,698	**1,762,263**	2,259,862

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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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	2017 Total Rs. 000	2016 Total Rs. 000
Cash and cash equivalents	1,287,738	6,433,273	-	-	-	-	-	**7,721,011**	7,388,308
Balances with Central Bank	7,765,246	-	-	-	-	-	-	**7,765,246**	9,090,026
Placements with banks	-	41,214,750	-	-	-	-	-	**41,214,750**	40,524,300
Derivative financial instruments	156,576	1,076,534	32,322	-	-	-	-	**1,265,432**	471,757
Other financial assets held-for-trading	4,762,430	-	-	-	-	-	-	**4,762,430**	756,106
Loans and receivables to banks	-	-	-	-	-	-	-	-	-
Loans and receivables to other customers	941,960	9,935,913	175,876,139	3,397,525	11,591,763	1,762,263	(766,514)	**202,739,049**	212,875,084
Financial investments AFS	150,869,348	-	-	-	-	-	-	**150,869,348**	122,514,575
Acceptances	-	-	5,218,210	767,567	253,776	-	-	**6,239,553**	6,506,718
Total	**165,783,298**	**58,660,470**	**181,126,671**	**4,165,092**	**11,845,539**	**1,762,263**	**(766,514)**	**422,576,819**	400,126,875

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

	Contractual residual 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	Total Rs. 000
2017	2,036,653	221	6,900	30,031	264,068	497,548	8,516,579	239,763	11,591,763
2016	1,894,481	1,056	56,262	10,705	841,213	2,584,793	1,105,950	336,238	6,830,698

The impairment charges for loans and receivables is disclosed in note 10. The movement in provision for impairment is disclosed in note 21.1

Collateral held and other credit enhancements and their financial effect

	2017		2016	
	Carrying amount LKR'000	Carrying amount LKR'000	Carrying amount LKR'000	Carrying amount LKR'000
Loans and receivables to banks	-	-	-	-
Loans and receivables to other customers	202,739,049	70,735,207	212,875,084	78,854,865

Collateral relating to past due but not impaired and impaired loans as at 31 December 2017 amounts to LKR 11,228,376,176/-

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.

39 Financial risk management (contd)

39.3 Liquidity risk (contd)

39.3.1 Management of liquidity and funding risk (contd)

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	2017 Total Rs. 000	2016 Total Rs. 000
Due to banks	24,347,978	7,809,740	12,397,683	36,939,135	3,724,248	79,517,976	11,554,113	2,591,848	178,882,721	151,585,134
Derivative financial instruments	1,032,732	-	-	-	-	-	-	-	1,032,732	383,472
Due to other customers	100,660,036	13,183,753	18,093,334	16 353,248	17,140,532	8,601,676	19,265,716	-	193,298,294	183,343,214
Acceptances	611,109	1,954,634	2,038,995	989,632	417,981	227,180	-	-	6,239,530	6,506,718
Total	126,651,855	22,948,127	32,530,011	54,282,015	21,282,761	88,346,832	30,819,829	2,591,848	379,453,277	341,818,538

Note : Maturity analysis for 2017 is based on undiscounted cash flows whereas comparatives are discounted.

39.3.2 Indicators

	2017	2016
Net loans to total assets	47%	52%
Loans to customer deposits	112%	116%
Liquid assets to short term liabilities*	380%	248%
Commitments to total loans	90%	84%

* *Liquidity Coverage ratio is indicated under 'Liquid Assets to Short Term Liabilities Ratio*

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 assets 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.

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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.

Foreign exchange position

Currency	Spot			Forward			Net open position	Net position in other exchange contracts	Overall exposure in other respective foreign currency	Overall exposure in Sri Lankan Rupees
	Assets	Liabilities	Net	Assets	Liabilities	Net				
USD	91,132.25	(148,706.87)	(57,574.62)	149,453.14	(14.07)	149,439.07	(470.31)	-	(3.08)	(470.31)
GBP	20,733.42	(25,815.91)	(5,082.49)	5,408.42	(316.53)	5,091.89	6.88	-	0.03	6.88
EUR	7,929.49	(9,119.30)	(1,189.81)	1,604.60	(414.65)	1,189.94	3.15	-	0.02	3.15
JPY	6,754.75	(6,768.59)	(13.84)	349.21	(334.66)	14.55	0.30	-	0.00	0.30
INR	-	-	-			-	-	-	-	-
AUD	14,877.79	(20,504.62)	(5,626.83)	5,821.81	(179.13)	5,642.68	7.06	-	0.06	7.06
CAD	6,834.00	(7,235.64)	(401.64)	402.40	-	402.40	(0.12)	-	(0.00)	(0.12)
Other	124,956.00	(112,483.80)	12,472.20	46,999.70	(60,298.67)	(13,298.97)	457.33	-	2.99	457.33
Total	273,217.70	(330,634.74)	(57,417.04)	210,039.27	(61,557.72)	148,481.55	(437.30)	-	(2.86)	(437.30)

Sensitivity of reported reserves to interest rate movements

AFS Reserve (Currency wise) USD'000	2017		
	Month end balances	+100bps	-100 bps
USD	(1,679)	(706)	706
LKR	8,407	(5,980)	5,980
AFS Total	6,728	(6,686)	6,686

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

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 (contd)

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	**36,411**	**32,781**	**5,455**	74,647	**905**	41,408	**116,960**
Incremental NII of the next							
Parallel movements in yield curve							
+100 bps	6,101	2,324	975	9,400	(4,015)	13,154	18,539
-100 bps	7,364	(1,377)	(218)	5,769	(6,366)	(7,605)	(8,202)
Ramp movements in yield curve*							
+100 bps	6,343	2,061	743	9,146	(4,796)	2,699	7,049
-100 bps	7,137	33	(2)	7,168	(6,031)	(5,234)	(4,097)

Projected NII of the thirteenth month to twenty fourth month

Base case	**36,411**	**32,781**	**5,455**	74,647	**905**	**41,408**	**116,960**
With +100 bps in 1st year	42,653	35,370	6,430	84,453	(1,890)	52,923	135,485
Difference	**6,242**	**2,589**	**975**	**9,805**	**(2,795)**	**11,515**	**18,525**
With -100 bps in 1st year	43,623	31,139	5,237	79,999	(6,144)	34,890	108,745
Difference	**7,211**	**(1,642)**	**(218)**	**5,352**	**(7,048)**	**(6,518)**	**(8,215)**

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

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 **Financial risk management (contd)**

39.4 **Market risk (contd)**

39.4.2 **Risk management (contd)**

Maturities of assets and liabilities

Figures in LKR'000	**Upto 1 month**	**Between 1 - 3 months**	**Between 3 - 6 months**	**Between 6 - 12 months**	**1 - 3 years**	**3 - 5 years**	**5 years and above**	**Total**
Cash and cash equivalent	7,721,011	-	-	-	-	-	-	7,721,011
Balances with Central Bank	7,765,246	-	-	-	-	-	-	7,765,246
Placements with banks	41,214,750	-	-	-	-	-	-	41,214,750
Derivative financial instruments	1,265,432	-	-	-	-	-	-	1,265,432
Other financial assets held-for-trading	40,677	-	346,818	54,144	370,674	3,950,117	-	4,762,430
Loans and receivables to banks	-	-	-	-	-	-	-	-
Loans and receivables to customers	64,616,400	33,733,863	13,275,480	8,840,644	37,373,821	36,338,721	8,560,120	202,739,049
Financial investments - available for sale	13,827,692	28,286,788	8,739,209	23,396,059	73,717,645	2,901,955	-	150,869,348
Property,plant and equipment	-	-	-	-	-	-	3,940,743	3,940,743
Other assets	4,422,883	6,437,994	989,632	417,981	227,202	-	2,131,910	14,627,602
Total assets	140,874,091	68,458,645	23,351,139	32,708,828	111,689,342	43,190,793	14,632,773	434,905,611
Due to banks	31,992,696	12,280,000	36,456,250	3,433,949	77,466,736	11,238,349	2,532,750	175,400,730
Derivative financial instruments	1,032,710	-	-	-	-	-	-	1,032,710
Due to other customers	113,844,014	18,093,295	14,959,323	15,679,466	5,601,860	12,547,083	-	180,725,041
Deferred tax liability	-	-	106,271	-	-	-	-	106,271
Current tax liability	-	641,051	641,051	640,916	-	-	-	1,923,018
Other liabilities	5,343,965	9,072,883	1,465,683	916,016	405,507	399,417	1,266,640	18,870,111
Equity	-	-	-	-	-	-	56,847,730	56,847,730
Total liabilities	152,213,385	40,087,229	53,628,578	20,670,347	83,474,103	24,184,849	60,647,120	434,905,611
Cumulative gap	(11,339,294)	28,371,416	(30,277,439)	12,038,481	28,215,239	19,005,944	(46,014,347)	-

The table below shows the contractual expiry by maturity of the Bank's contingent liabilities and commitments. The Bank expects that not all of the contingent liabilities or commitments will be drawn before expiry of the commitments.

	Upto 1 month	**Between 1 - 3 months**	**Between 3 - 6 months**	**Between 6 - 12 months**	**1 - 3 years**	**3 - 5 years**	**5 years and above**	**Total**
Performance bonds	318,365	102,922	128,030	705,002	3,587,489	1,294,600	-	6,136,408
Letters of credit	1,774,105	3,038,041	2,537,342	662,994	-	-	-	8,012,482
Other contingent items	4,015,392	5,995,921	6,718,725	5,309,661	6,633,040	17,502,912	-	46,175,651
Undrawn loan commitments	181,836,466	-	-	-	-	-	-	181,836,466
Foreign exchange contracts	76,525,413	73,227,739	34,374,376	63,866,578	3,224,391	-	-	251,218,497
Derivatives- principal amount	-	-	-	10,372,507	11,512,500	-	-	21,885,007
Other contra accounts	17,999,795	-	-	-	-	-	-	17,999,795
	282,469,536	82,364,623	43,758,473	80,916,742	24,957,420	18,797,512	-	533,264,306

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial risk management (contd)

39.4 Market risk (contd)

39.4.2 Risk management (contd)

Sensitivity analysis of assets and liabilities

Figures in LKR'000	Upto 1 month	Between 1 - 3 months	Between 3 - 6 months	Between 6 - 12 months	1 - 3 years	3 - 5 years	5 years and above	Non-Sensitive	Total
Cash and cash equivalent	-	-	-	-	-	-	-	7,721,011	7,721,011
Balances with Central Bank	-	-	-	-	-	-	-	7,765,246	7,765,246
Placements with banks	41,214,750	-	-	-	-	-	-	-	41,214,750
Derivative financial instruments	1,265,432	-	-	-	-	-	-	-	1,265,432
Other financial assets held-for-trading	40,677	-	346,818	54,144	370,674	3,950,117	-	-	4,762,430
Loans and receivables to banks	-	-	-	-	-	-	-	-	-
Loans and receivables to customers	94,068,286	58,949,140	14,161,656	6,735,939	9,171,173	15,919,251	1,688,293	2,045,311	202,739,049
Financial investments - available for sale	13,827,692	28,286,788	8,739,209	23,396,059	73,717,645	2,901,955	-	-	150,869,348
Property,plant and equipment	-	-	-	-	-	-	-	3,940,743	3,940,743
Other assets	2,565,743	2,038,995	989,632	417,981	227,202	-	-	8,388,049	14,627,602
Total assets	**152,982,580**	**89,274,923**	**24,237,315**	**30,604,123**	**83,486,694**	**22,771,323**	**1,688,293**	**29,860,360**	**434,905,611**
Due to banks	89,778,376	53,106,395	14,231,643	2,746,882	383,031	6,208,771	-	8,945,632	175,400,730
Derivative financial instruments	1,032,710	-	-	-	-	-	-	-	1,032,710
Due to other customers	70,739,107	18,093,333	14,959,316	15,679,493	5,601,860	12,547,076	-	43,104,856	180,725,041
Deferred tax liability	-	-	-	-	-	-	-	106,271	106,271
Current tax liability	-	-	-	-	-	-	-	1,923,018	1,923,018
Other liabilities	2,565,743	2,038,995	989,632	417,981	227,202	-	-	12,630,558	18,870,111
Equity	-	-	-	-	-	-	-	56,847,730	56,847,730
Total liabilities	**164,115,936**	**73,238,723**	**30,180,591**	**18,844,356**	**6,212,093**	**18,755,847**	**-**	**123,558,065**	**434,905,611**
Cumulative gap	**(11,133,356)**	**16,036,200**	**(5,943,276)**	**11,759,767**	**77,274,601**	**4,015,476**	**1,688,293**	**(93,697,705)**	**-**

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 fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data.

Some of the key action taken to mitigate operational risk include the following :
- Classification of all information based on the potential risk to HSBC, HSBC's customers and related parties. This classification is used to invoke policies and procedures to protect the confidentiality and integrity of HSBC information.
- Due diligence performed by business departments which forms part of the Risk Assessment process. Selecting a financially viable vendor with appropriate capability, skills and experience is essential part of the HSBC Vendor due diligence process in managing risk.
- HSBC has also undertaken steps to mitigate the risk of continuation of business through comprehensive Business Continuity Planning, taking into account the risks to the business, impact analysis, resource requirements etc. The Business Continuity Plans are updated regularly, tested and approved. The plans describes how normal business can be resumed following an adverse event or business interruption ensuring minimum impact to the business and customers.
- With regard to outsourcing of activities, HSBC Group policy is to outsource activities either internally to Global Service Centre's (GSCs) or externally, to third party service providers, where this enables the work to be performed more efficiently and at a lower cost than can be achieved within the business, due to economies of scale, specialist knowledge or resource constraints. Guidance on the outsourcing of work is contained in the Group policies & procedures and the outsource direction issued by the Central Bank of Sri Lanka.

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.

Total operational losses for 2017 for HSBC Sri Lanka was USD375,000.

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39 Financial risk management (contd)

39.5 Operational risk (contd)

39.5.1 Capital management

Qualitative disclosures

The Branch'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, accumulated other comphrehensive income, general and other reserves. The assigned capital is the amount provided by HSBC Asia Pacific to conduct its operation in Sri Lanka.

Tier 2 Capital – Supplementary capital
Revaluation reserves is the main constituent of supplementary capital for the Branch. 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)	**2017**	2016
	Rs'000	Rs'000
Assigned capital	**3,152,358**	3,152,358
Statutory reserve fund	**2,350,854**	2,222,693
Published retained profits (net of expected profit remmitances)	**31,040,434**	37,475,748
Accumulated other comphrehensive income, general and other reserves	**9,100,389**	10,282,164
Total qualifying tier 1 capital prior to deductions	**45,644,036**	53,132,963
Deductions to tier 1 capital	**(218,198)**	531,603
Net deferred tax assets	**-**	545,073
Amounts due to head office and branches outside Sri Lanka in Sri Lanka Rupees (-)	**(218,198)**	(13,470)
Amounts due from head office and branches outside Sri Lanka in foreign currency (Net)	**-**	-
Tier 1 capital	**45,862,234**	52,601,360
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	**46,219,151**	52,958,277

* 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.

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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.

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 offices 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)	**2017**	2016
	Rs.'000	Rs.'000
Credit risk	**213,931,330**	204,167,278
Market risk	**21,840,907**	19,527,360
Operational risk	**29,399,910**	32,748,405
Total risk-weighted assets	**265,172,147**	256,443,043
Capital ratios (Audited)		
Tier 1 ratio	**17.30%**	20.51%
Total capital ratio	**17.43%**	20.65%

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40 Fair value of financial assets and liabilities

40.1 Fair value of financial instruments not carried at fair value

Assets	**Carrying value Rs'000**	**Fair value Rs'000**
Cash and cash equivalents	7,721,011	7,721,011
Balances with Central Bank	7,765,246	7,765,246
Placements with banks	41,214,750	41,214,750
Loans and receivables to banks	-	-
Loans and receivables to other customers	202,739,049	205,132,350
Acceptances and endorsements	6,239,553	6,239,553
Liabilities		
Due to banks	175,400,730	175,400,730
Due to customers	180,725,041	180,725,041
Acceptances and endorsements	6,239,553	6,239,553

Note:
For financial instruments other than "Loans and receivables to other customers", carrying amount is a reasonable approximation of fair value because, for example, they are short term in nature or re-price to current market rates frequently.

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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 2017	**Level 1 Rs'000**	**Level 2 Rs'000**	**Level 3 Rs'000**
Assets			
Other financial assets held-for-trading	-	4,762,430	-
Derivative financial instruments	7,682	1,257,749	-
Financial investments : available-for-sale	-	150,869,348	-
	7,682	156,889,527	-
Liabilities			
Derivatives	4,123	1,028,587	-
	4,123	1,028,587	-
As at 31 December 2016			
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			
Derivative financial instruments	2,481	380,991	-
	2,481	380,991	-

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40 Fair value of financial assets and liabilities (contd)

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	2017 Assets Rs'000	2017 Liabilities Rs'000
As at 1 January	-	-
Total gains / (losses) recognised in profit or loss	-	-
Settlements	-	-
As at 31 December	-	-

	2016 Assets Rs'000	2016 Liabilities Rs'000
As at 1 January	95,261	343
Total gains/(losses) recognised in profit or loss	(95,261)	(343)
Settlements	-	-
As at 31 December	-	-

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 (contd)

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. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

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.

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41 Basel III disclosures

41.1 Key Regulatory Ratios - Capital and Liquidity

	2017 As at 31 December	2016 As at 31 December
Regulatory Capital Adequacy *		
Common Equity Tier 1, Rs. '000	45,862,234	-
Tier 1 Capital, Rs. '000	45,862,234	52,601,360
Total Capital, Rs. '000	46,219,151	52,958,277
Common Equity Tier 1 Capital Ratio, as % of Risk Weighted Assets (Minimum Requirement, 5.75%)	17.30%	-
Tier 1 Capital Ratio, as % of Risk Weighted Assets (Minimum Requirement, 7.25%)	17.30%	20.51%
Total Capital Ratio, as % of Risk Weighted Assets (Minimum Requirement, 11.25%)	17.43%	20.65%

* With effect from 1 July 2017, Regulatory Capital and Ratios are computed in accordance to Basel III minimum capital requirements whilst comparatives were reported based on Basel II.

	2017 As at 31 December	2016 As at 31 December
Regulatory Liquidity		
Statutory Liquid Assets, Rs.'000		
Domestic Banking unit	103,016,474	104,550,306
Off-Shore Banking Unit	82,536,029	62,436,840
Statutory Liquid Assets Ratio,% (Minimum Requirement, 20%)		
Domestic Banking Unit	55.67%	54.87%
Off-Shore Banking Unit	47.49%	37.91%
Liquidity Coverage Ratio (%) - Rupee (Minimum Requirement, 2017 - 80%; 2016 - 70%)	216.40%	194.69%
Liquidity Coverage Ratio (%) - All currency (Minimum Requirement, 2017 - 80%; 2016 - 70%)	379.95%	349.92%

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41 Basel III disclosures (contd)

41.2 Computation of capital adequacy ratio

Item	Amount as at Dec 2017 (LKR '000)
Common Equity Tier I (CETI) Capital after Adjustments	**45,862,234**
Total Common Equity Tier I (CET1) Capital	**45,644,036**
Equity capital or stated capital/assigned capital	3,152,358
Reserve fund	2,350,854
Published retained earnings/(accumulated retained losses)	31,040,434
Accumulated other comprehensive income (OCI)	3,823,696
General and other disclosed reserves	5,276,693
Total Adjustments to CET1 Capital	**(218,198)**
Amount due to head office & branches outside Sri Lanka in Sri Lanka Rupees	(218,198)
Tier 2 Capital after Adjustments	**356,917**
Total Tier 2 Capital	**356,917**
Revaluation gains	356,917
Total Adjustments to Tier 2 Capital	-
Total Tier 1 Capital	**45,862,234**
Total Capital	**46,219,151**
Total Risk Weighted Assets (RWA)	**265,172,147**
RWAs for Credit Risk	213,931,330
RWAs for Market Risk	21,840,907
RWAs for Operational Risk	29,399,910
CET1 Capital Ratio (including Capital Conservation Buffer,	
Countercyclical Capital Buffer & Surcharge on D-SIBs) (%)	**17.30%**
of which: Capital Conservation Buffer (%)	1.25%
of which: Countercyclical Buffer (%)	
of which: Capital Surcharge on D-SIBs (%)	
Total Tier 1 Capital Ratio (%)	**17.30%**
Total Capital Ratio (including Capital Conservation Buffer, Countercyclical	**17.43%**
Capital Buffer & Surcharge on D-SIBs) (%)	
of which: Capital Conservation Buffer (%)	1.25%
of which: Countercyclical Buffer (%)	
of which: Capital Surcharge on D-SIBs (%)	

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41 **Basel III disclosures (contd)**

41.3 **Computation of Liquidity Coverage Ratio**

Item	Amount (LKR'000)		Amount (LKR'000)	
	31-Dec-17		31-Dec-16	
	Un-weighted	Weighted	Un-weighted	Weighted
Total Stock of High-Quality Liquid Assets (HQLA)	**89,368,940**	**89,368,940**	**73,488,509**	**73,488,509**
Total Adjusted Level 1A Assets	**89,370,909**	**89,370,909**	**73,490,605**	**73,490,605**
Level 1 Assets	**89,368,940**	**89,368,940**	**73,488,509**	**73,488,509**
Total Adjusted Level 2A Assets	-	-	-	-
Level 2A Assets	-	-	-	-
Total Adjusted Level 2B Assets	-	-	-	-
Level 2B Assets	-	-	-	-
Total Cash Outflows	**467,488,187**	**77,314,888**	**446,501,904**	**78,809,693**
Deposits	107,930,534	10,793,053	108,504,076	10,850,408
Unsecured Wholesale Funding	97,777,035	48,135,091	96,922,344	49,219,208
Secured Funding Transactions	227,989	-	207,438	-
Undrawn Portion of Committed (Irrevocable) Facilities and Other Contingent Funding Obligations	248,400,559	5,234,674	225,076,160	2,948,192
Additional Requirements	13,152,069	13,152,069	15,791,886	15,791,886
Total Cash Inflows	**74,024,597**	**53,793,385**	**77,973,687**	**57,808,658**
Maturing Secured Lending Transactions Backed by Collateral				
Committed Facilities				
Other Inflows by Counterparty which are Maturing within 30 Days	65,815,850	53,515,300	72,850,355	57,712,328
Operational Deposits	7,915,352	-	4,958,282	-
Other Cash Inflows	293,394	278,085	165,050	96,331
Liquidity Coverage Ratio (%) (Stock of High Quality Liquid Assets/Total Net Cash Outflows over the Next 30 Calendar Days) * 100		**379.95%**		**349.93%**

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41 Basel III disclosures (contd)

41.4 Credit Risk under standardised approach - credit risk exposures and credit risk mitigation (CRM) effects

Asset Class	Amount (LKR'000) as at 31December2017					
	Exposures before Credit Conversion Factor (CCF) and CRM		Exposures post CCF and CRM		RWA and RWA Density (%)	
	On-Balance Sheet Amount	Off-Balance Sheet Amount	On-Balance Sheet Amount	Off-Balance Sheet Amount	RWA	RWA Density(ii)
Claims on Central Government and CBSL	168,414,487	7,675,000	168,414,487	153,500	-	0.00%
Claims on Foreign Sovereigns and their Central Banks	-	-	-	-	-	-
Claims on Public Sector Entities	-	-	-	-	-	-
Claims on Official Entities and Multilateral Development Banks	-	-	-	-	-	-
Claims on Banks Exposures	5,346,277	113,242,512	5,346,277	14,472,075	5,969,019	30.12%
Claims on Financial Institutions	175,000	10,711,127	175,000	500,000	675,000	100.00%
Claims on Corporates	153,414,561	208,633,443	153,095,431	26,788,809	168,069,940	93.43%
Retail Claims	41,387,893	46,838,062	33,737,362	88,330	25,681,689	75.92%
Claims Secured by Residential Property	3,138,979	-	3,138,979	-	2,302,399	73.35%
Claims Secured by Commercial Real Estate	-	-	-	-	-	-
Non-Performing Assets (NPAs)	1,153,928	-	1,153,928	-	1,658,102	143.69%
Higher-risk Categories	-	-	-	-	-	-
Cash Items and Other Assets	12,063,335	-	12,063,335	-	9,575,181	79.37%
Total	**385,094,458**	**387,100,145**	**377,124,798**	**42,002,714**	**213,931,330**	

Note : RWA Density – Total RWA/Exposures post CCF and CRM.

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41 **Basel III disclosures (contd)**

41.5 **Credit risk under standardised approach: exposures by asset classes and risk weights**

Description	Amount (LKR'000) as at 31December2017 (Post CCF & CRM)							
Risk Weight / Asset classes	0%	20%	50%	75%	100%	150%	>150%	Total Credit Exposures Amount
Claims on Central Government and Central Bank of Sri Lanka	168,567,987	-	-	-	-	-	-	168,567,987
Claims on Foreign Sovereigns and their Central Banks	-	-	-	-	-	-	-	-
Claims on Public Sector Entities	-	-	-	-	-	-	-	-
Claims on Official Entities and Multilateral Development Banks	-	-	-	-	-	-	-	-
Claims on Banks Exposures	-	16,018,366	2,069,279	-	1,730,706	-	-	19,818,351
Claims on Financial Institutions	-	-	-	-	675,000	-	-	675,000
Claims on Corporates	-	14,091,716	1,081,854	-	164,710,670	-	-	179,884,240
Retail Claims	-	-	-	32,576,014	1,249,679	-	-	33,825,693
Claims Secured by Residential Property	-	-	1,673,161	-	1,465,818	-	-	3,138,979
Claims Secured by Commercial Real Estate	-	-	-	-	-	-	-	-
Non-Performing Assets (NPAs)			12,004		121,571	1,020,353		1,153,928
Higher-risk Categories	-	-	-	-	-	-	-	-
Cash Items and Other Assets	1,287,738	1,500,519			9,275,078			12,063,335
Total	169,855,725	31,610,601	4,836,298	32,576,014	179,228,521	1,020,353	-	419,127,512

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41 Basel III disclosures (contd)

41.6 Market risk under standardised measurement method

Item	**(LKR'000) as at 31 December 2017**
(a) RWA for Interest Rate Risk	**21,421,298**
General Interest Rate Risk	
(i) Net Long or Short Position	2,409,896
(ii) Horizontal Disallowance	
(iii) Vertical Disallowance	
(iv) Options	
Specific Interest Rate Risk	
(b) RWA for Equity	
(i) General Equity Risk	
(ii) Specific Equity Risk	
(c) RWA for Foreign Exchange & Gold	**419,609**
Capital Charge for Market Risk [(a) + (b) + (c)] * CAR	**2,457,102**

41.7 Operational risk under basic indicator approach

	Capital Charge Factor	**Gross Income (LKR'000) as at 31-Dec-17**		
		1st Year	**2nd Year**	**3rd Year**
The Basic Indicator Approach	15%	21,003,776	22,316,906	22,829,116
Capital Charges for Operational Risk (LKR'000)				
The Basic Indicator Approach	3,307,490			
Risk Weighted Amount for Operational Risk (LKR'000)				
The Basic Indicator Approach	29,399,910			

41 Basel III disclosures (contd)

41.8

Differences between accounting and regulatory scopes and mapping of financial statement categories with regulatory risk categories – bank only

Item	Amount (LKR '000) as at 31December2017				
	a	b	c	d	e
	Carrying Values as Reported in Published Financial Statements	Carrying Values under Scope of Regulatory Reporting	Subject to Credit Risk Framework	Subject to Market Risk Framework	Not subject to Capital Requirements or Subject to Deduction from Capital
Assets					
Cash and Cash Equivalents	7,721,011	7,720,364	5,433,686	4,389,223	2,286,679
Balances with Central Banks	7,765,246	7,765,246	7,765,246		
Placements with Banks	41,214,750	41,214,750		18,727,000	22,487,750
Derivative Financial Instruments	1,265,432	1,265,432	1,254,358		11,074
Other Financial Assets Held-For-Trading	4,762,430	139,153,617	139,153,617	139,153,617	
Financial Assets Designated at Fair Value through Profit or Loss	-	-	-		
Loans and Receivables to Banks	-	-	-		
Loans and Receivables to Other Customers	202,739,049	203,377,533	204,390,693	20,505,506	(1,013,160)
Financial Investments - Available-For-Sale	150,869,348	-	-	0	
Financial Investments - Held-To-Maturity	-	16,365,632	16,365,632	5,620,632	
Investments in Subsidiaries	-	-	-		
Investments in Associates and Joint Ventures	-	-	-		
Property, Plant and Equipment	3,940,743	3,940,743	3,940,743		
Investment Properties	-	-	-		
Goodwill and Intangible Assets	-	-	-		
Deferred Tax Assets	-	182,925	-		182,925
Other Assets	14,627,602	6,790,484	6,790,484	1,734,168	
Liabilities					
Due to Banks	175,400,730	175,400,730		13,407,002	161,993,728
Derivative Financial Instruments	1,032,710	1,032,710		960,206	72,504
Other Financial Liabilities Held-For-Trading		-			
Financial Liabilities Designated at Fair Value Through Profit or Loss		-			
Due to Other Customers	180,725,041	180,725,041		43,593,795	137,131,246
Other Borrowings					
Debt Securities Issued					
Current Tax Liabilities	1,923,018	1,785,884			1,785,884
Deferred Tax Liabilities	106,271	-			-
Other Provisions					
Other Liabilities	18,870,111	12,632,456		6,120,701	6,511,756
Due to Subsidiaries					
Subordinated Term Debts					
Off-Balance Sheet Liabilities					
Guarantees	46,175,651	46,175,651	46,175,651		
Performance Bonds	6,136,407	6,136,407	6,136,407		
Letters of Credit	8,012,482	8,012,482	8,012,482		
Other Contingent Items	21,885,007	28,124,560	28,124,560	2,545,254	
Undrawn Loan Commitments	181,836,466	181,836,466	181,836,466		
Other Commitments	269,218,293	162,995,643	116,814,579	161,153,526	26,283,591
Shareholders' Equity					
Equity Capital (Stated Capital)/Assigned Capital	3,152,358	3,152,358	3,152,358		
of which Amount Eligible for CET1			3,152,358		
of which Amount Eligible for AT1					
Retained Earnings	37,173,351	39,092,495	31,040,434		
Accumulated Other Comprehensive Income	6,372,827		3,823,696		
Statutory reserve fund	2,350,855	2,222,694	2,350,854		
Other Reserves	7,798,339	11,732,354	5,276,693		
Total Shareholders' Equity	**56,847,730**	**56,199,902**	**45,644,036**		

Notes :
- Items subject to both credit risk and market risk are reported in both columns, therefore in such instances sum of column c to e may be greater than column b
- Amounts reported in column 'Subject to credit risk framework' under Shareholders' Equity represent the position of regulatory capital as at 31 December 2017 computed based on Banking Act Direction No. 01 of 2016 - Capital requirements under Basel III