

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

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED
31 DECEMBER 2019**



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

FOR THE YEAR ENDED 31 DECEMBER 2019

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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 audit of the financial statements

Our opinion

In our opinion, the accompanying financial statements give a true and fair view of the financial position of Hongkong and Shanghai Banking Corporation Limited Sri Lanka Branch ("the Branch") as at 31 December 2019, and of its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

What we have audited

The financial statements of the Branch, which comprise:

- the statement of financial position as at 31 December 2019;
- income statement and the statement of comprehensive income for the year then ended;
- the statement of changes in equity for the year then ended;
- the statement of cash flows for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies.

Basis for opinion

We conducted our audit in accordance with Sri Lanka Auditing Standards (SLAuSs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report.

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

Independence

We are independent of the Branch in accordance with the Code of Ethics issued by CA Sri Lanka (Code of Ethics), and we have fulfilled our other ethical responsibilities in accordance with the Code of Ethics.

Other information

Management is responsible for the other information. The other information comprises the supplemental Basel III disclosures but does not include the financial statements and our auditor's report thereon.

PricewaterhouseCoopers, P. O. Box 918, 100 Braybrooke Place, Colombo 2, Sri Lanka
T: +94 (11) 771 9700, 771 9838, F: +94 (11) 230 3197, www.pwc.com/lk

Partners D T S H Mudalige FCA, C S Manoharan FCA, Ms S Hadgie FCA, Ms S Perera ACA, N R Gunasekera FCA
 T U Jayasinghe FCA, H P V Lakdeva FCA, M D B Boyagoda ACA

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

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

If, based on the work we have performed on the other information that we obtained prior to the date of this auditor's report, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of management and those charged with governance 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.

In preparing the financial statements, management is responsible for assessing the Branch's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Branch or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Branch's financial reporting process.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SLAuSs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

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

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.



- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Branch's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Branch's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Branch to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

(Signed)

**CHARTERED ACCOUNTANTS
COLOMBO
27 March 2020**

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

FOR THE YEAR ENDED 31 DECEMBER

	Note	2019 Rs.'000	2018 Rs.'000
Interest income		31,074,853	29,657,388
Interest expenses		<u>(12,441,140)</u>	<u>(11,211,749)</u>
Net interest income	6	18,633,713	18,445,639
Fee and commission income		4,232,795	4,046,719
Fee and commission expenses		<u>(1,279,789)</u>	<u>(1,006,278)</u>
Net fee and commission income	7	2,953,006	3,040,441
Net gain from trading	8	1,366,859	1,776,387
Net fair value gains from financial instruments at fair value through profit or loss	9	379,949	312,260
Other operating income (net)	10	<u>42,621</u>	<u>60,244</u>
Total operating income		23,376,148	23,634,971
Impairment charge for loans and other losses	11	<u>(810,477)</u>	<u>(168,847)</u>
Net operating income		22,565,671	23,466,124
Personnel expenses	12	<u>(4,018,889)</u>	<u>(3,852,704)</u>
Other expenses	13	<u>(8,497,914)</u>	<u>(7,436,378)</u>
Operating profit before Value Added Tax and Nation Building Tax		10,048,868	12,177,042
Value Added Tax and Nation Building Tax	14.4	<u>(1,723,289)</u>	<u>(2,120,039)</u>
Profit before tax		8,325,579	10,057,003
Income tax expense	14.1	<u>(2,081,999)</u>	<u>(3,935,439)</u>
Profit for the year		6,243,580	6,121,564

Figures in brackets indicate deductions.

The financial statements are to be read in conjunction with the related notes as set out on pages 9 to 91, which form an integral part of the financial statements of the Branch. The Report of the Auditors is given on pages 1 to 3.

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

FOR THE YEAR ENDED 31 DECEMBER

	Note	2019 Rs.'000	2018 Rs.'000
Profit for the year		6,243,580	6,121,564
Other comprehensive income / (expenses)			
Items that may be reclassified to profit or loss in subsequent periods			
Net gains / (losses) on investments in debt instruments measured at fair value through other comprehensive income		1,325,096	(1,655,322)
(Losses) / gains from the financial statements of foreign currency operation		(187,900)	3,921,085
Tax related to above		(371,027)	463,490
Net other comprehensive income that may be reclassified to profit or loss in subsequent periods		766,169	2,729,253
Items that may not be reclassified to profit or loss in subsequent periods			
Remeasurement of post-employment benefit obligations		(124,714)	33,677
(Losses) / gains on revaluation of land and buildings		(126,228)	872,949
Tax related to above		72,366	(852,087)
Net other comprehensive (loss) / income that may not be reclassified to profit or loss in subsequent periods		(178,576)	54,539
Net other comprehensive income		587,593	2,783,792
Total comprehensive income for the year		6,831,173	8,905,356

Figures in brackets indicate deductions.

The financial statements are to be read in conjunction with the related notes as set out on pages 9 to 91, which form an integral part of the financial statements of the Branch. The Report of the Auditors is given on pages 1 to 3.

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

AS AT 31 DECEMBER

	Note	2019 Rs.'000	2018 Rs.'000
ASSETS			
Cash and cash equivalents	16	33,986,285	23,502,316
Balances with the Central Bank of Sri Lanka	17	9,740,145	7,332,880
Placements with banks	18	27,214,500	49,385,700
Derivative financial instruments	19	812,121	4,466,754
Financial assets measured at fair value through profit or loss	20	4,751,028	11,516,593
Financial assets at amortised cost – Loans and advances	21	260,155,127	255,830,603
Financial assets measured at fair value through other comprehensive income	22	107,854,554	100,949,137
Financial assets at amortised cost - debt instruments	23	3,088,314	5,308,259
Property, plant and equipment	24	5,212,836	4,789,830
Other assets	27	14,517,471	14,357,782
Total assets		467,332,381	477,439,854
LIABILITIES			
Due to banks	28	170,599,897	184,786,888
Derivative financial instruments	29	1,052,576	3,875,848
Financial liabilities at amortised cost - due to depositors	30	209,805,122	205,873,323
Retirement benefit obligations deficit	31	79,213	23,005
Current tax liabilities		357,774	1,925,367
Deferred tax liabilities	26	366,423	132,730
Other liabilities	32	18,445,106	21,146,952
Total liabilities		400,706,111	417,764,113
EQUITY			
Assigned capital	33	3,152,358	3,152,358
Statutory reserve fund	34	2,598,158	2,473,286
Other reserves	35	15,770,402	16,739,084
Retained earnings		45,105,352	37,311,013
Total equity		66,626,270	59,675,741
Total equity and liabilities		467,332,381	477,439,854
Contingent liabilities and commitments	38	493,621,668	612,582,703
Memorandum Information			
Number of employees		1,224	1,245
Number of branches		14	14

The financial statements are to be read in conjunction with the related notes as set out on pages 9 to 91, which form an integral part of the financial statements of the Branch. The Report of the Auditors is given on pages 1 to 3.

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.

Mark G Prothero
Chief Executive Officer
(Signed)

27th March 2020
Colombo

Angelo Pillai
Chief Financial Officer
(Signed)

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

FOR THE YEAR ENDED 31 DECEMBER 2019

	Assigned Capital	Exchange Equalisation Reserve	IFA Reserve	FVOCI Reserve	SBP Reserve	Statutory Reserve Fund	Revaluation Reserve	Retained Earnings	Total Equity
	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000
Balance as at 1 January 2018	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
SLFRS 9 Provisions - Day 1 impact	-	-	-	-	-	-	-	(1,234,205)	(1,234,205)
Restated balance as at 1 January 2018	3,152,358	5,629,182	5,108,459	743,645	168,234	2,350,855	2,521,649	35,939,143	55,613,525
Total comprehensive income for the year									
Profit for the year	-	-	-	-	-	-	-	6,121,564	6,121,564
Other comprehensive income (net of tax)	-	3,921,085	-	(1,191,832)	-	-	40,354	14,185	2,783,792
Total comprehensive income for the year	-	3,921,085	-	(1,191,832)	-	-	40,354	6,135,749	8,905,356
Transactions with non equity holders, recognised directly in equity									
Depreciation on revaluation reserve	-	-	-	-	-	-	(5,514)	5,514	-
Deferred tax on revaluation	-	-	-	-	-	-	1,544	(1,544)	-
Transactions with equity holders, recognised directly in equity									
Transfers to reserves during the year	-	-	-	-	219	122,431	-	(122,431)	219
Restricted shares	-	-	-	-	-	-	-	6,822	6,822
Transfer to IFA reserve	-	-	(382,751)	-	-	-	-	382,751	-
Impairment on FVOCI	-	-	-	184,810	-	-	-	-	184,810
Profit transferred to head office	-	-	-	-	-	-	-	(5,034,991)	(5,034,991)
Total transactions with equity holders	-	-	(382,751)	184,810	219	122,431	(3,970)	(4,763,879)	(4,843,140)
Balance as at 31 December 2018	3,152,358	9,550,267	4,725,708	(263,377)	168,453	2,473,286	2,558,033	37,311,013	59,675,741
Balance as at 1 January 2019	3,152,358	9,550,267	4,725,708	(263,377)	168,453	2,473,286	2,558,033	37,311,013	59,675,741
Profit for the year	-	-	-	-	-	-	-	6,243,580	6,243,580
Other comprehensive income (net of tax)	-	(187,900)	-	954,069	-	-	(90,833)	(87,743)	587,593
Total comprehensive income for the year	-	(187,900)	-	954,069	-	-	(90,833)	6,155,837	6,831,173
Transactions recognised directly in equity									
Depreciation on revaluation reserve	-	-	-	-	-	-	(7,029)	7,029	-
Deferred tax on revaluation reserve	-	-	-	-	-	-	1,917	(1,917)	-
Transactions with equity holders, recognised directly in equity									
Transfers to reserves during the year	-	-	-	-	48	124,872	-	(124,872)	48
Restricted shares	-	-	-	-	-	-	-	2,629	2,629
Transfer from IFA reserve	-	-	(1,755,633)	-	-	-	-	1,755,633	-
Impairment on FVOCI	-	-	-	116,679	-	-	-	-	116,679
Total transactions with equity holders	-	-	(1,755,633)	116,679	48	124,872	(5,112)	1,638,502	119,356
Balance as at 31 December 2019	3,152,358	9,362,367	2,970,075	807,371	168,501	2,598,158	2,462,088	45,105,352	66,626,270

Figures in brackets indicate deductions.

The financial statements are to be read in conjunction with the related notes as set out on pages 9 to 91, which form an integral part of the financial statements of the Branch. The Report of the Auditors is given on pages 1 to 3.

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

FOR THE YEAR ENDED 31 DECEMBER

	Note	2019 Rs.'000	2018 Rs.'000
Cash flow from operating activities			
Interest received		32,202,507	30,308,851
Interest paid		(10,628,905)	(10,275,415)
Fees and commission received		1,673,217	3,040,441
Net receipts from trading activities		1,366,860	1,776,386
Payments to employees		(4,004,775)	(3,832,331)
VAT and NBT on financial services		(1,649,215)	(2,432,312)
Receipts from other operating activities		723,049	697,031
Payments to other operating activities		(7,775,933)	(6,547,354)
Operating profit before changes in operating assets and liabilities		11,906,805	12,735,297
(Increase) / decrease in operating assets			
Balances with Central Bank of Sri Lanka		(2,407,264)	432,365
Financial assets at amortised cost - loans and advances		21,066,647	(63,293,388)
Treasury bills and bonds		3,708,867	36,239,862
Other assets		731,261	(2,983,837)
		23,099,511	(29,604,998)
Increase / (decrease) in operating liabilities			
Financial liabilities at amortised cost - due to depositors		3,931,798	25,148,283
Financial liabilities at amortised cost - due to other borrowers		(14,186,991)	9,386,158
Other liabilities		(7,186,110)	3,793,065
		(17,441,303)	38,327,506
Net cash generated from operating activities before income tax		17,565,013	21,457,805
Income tax paid		(4,835,077)	(4,376,214)
Net cash generated from operating activities		12,729,936	17,081,591
Cash flow from investing activities			
Proceeds from disposal of property, plant and equipment		336,602	22,714
Acquisition of property, plant and equipment		(531,313)	(281,376)
Net cash used in investing activities		(194,711)	(258,662)
Cash flow from financing activities			
Profit transferred to Head Office		-	(5,034,991)
Net cash used in financing activities		-	(5,034,991)
Net increase in cash and cash equivalents		12,535,225	11,787,938
Cash and cash equivalents at the beginning of period	16	23,502,316	7,721,011
Exchange difference in respect of cash and cash equivalents		(2,051,256)	3,993,367
Cash and cash equivalents at the end of the period	16	33,986,285	23,502,316

Figures in brackets indicate deductions.

The financial statements are to be read in conjunction with the related notes as set out on pages 9 to 91, which form an integral part of the financial statements of the Branch. The Report of the Auditors is given on pages 1 to 3.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS**

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”/ “HSBC”) 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. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This note provides a list of the significant accounting policies adopted in the preparation of these financial statements. These policies have been consistently applied in all years presented, unless otherwise stated.

2.1 Basis of preparation

2.1.1 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), relevant interpretations of the Standard Interpretations Committee (“SIC”) and International Financial Reporting Interpretations Committee (“IFRIC”). Sri Lanka accounting standards further comprises of Statements of Recommended Practices (SORPs), Statements of Alternative Treatments (SOATs) and financial reporting guidelines issued by the Institute of Chartered Accountants of Sri Lanka and comply with the requirements of the Banking Act No. 30 of 1988 and subsequent amendments thereto.

2.1.2 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;

- Financial instruments measured at fair value through profit or loss, including derivative financial instruments;
- Financial instruments measured at fair value through other comprehensive income;
- Defined benefit obligations and the related Plan assets are measured at fair value.;
- Freehold land and buildings are measured at fair value.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTD)

2.1 Basis of preparation(contd)

2.1.3 Use of estimates and judgement

The preparation of financial statements in conformity with Sri Lanka Accounting Standards require the use of certain critical accounting estimates. It also requires the management to exercise its judgement in the process of applying the Branch's accounting policies.

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 areas involving a higher degree of judgement or complexity, or areas where assumptions are significant to the Branch financial statements are disclosed in note 4.

2.1.4 Changes in accounting standards

The following amendments to the Sri Lanka accounting standards that are relevant for the preparation of financial statements have been adopted by the Branch, (a) new standards and amendments that are effective for the first time for periods commencing on or after 1 January 2019 (ie years ending 31 December 2019) and (b) forthcoming requirements, being standards and amendments that will become effective on or after 1 January 2020.

(a) New accounting standards, amendments and interpretations – applicable 1 January 2019

The Branch has applied following standards and interpretations for the first time to financial reporting periods commencing on or after 1 January 2019:

The Branch had to change its accounting policies as a result of adopting SLFRS 16. The Branch elected to adopt the new rules retrospectively but recognised the cumulative effect of initially applying the new standard on 1 January 2019. This is disclosed in note 5. The other amendments listed below did not have any impact on amounts recognised in prior periods and are not expected to significantly affect the current or future periods.

(i) SLFRS 16 Leases

SLFRS 16 Leases will affect primarily the accounting by lessees and will result in the recognition of almost all leases on statement of financial position. 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.

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 HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTD)

2.1 Basis of preparation(contd)

2.1.4 Changes in accounting standards (contd)

(a) New accounting standards, amendments and interpretations – applicable 1 January 2019 (contd)

(i) SLFRS 16 Leases (contd)

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

Adoption of IFRS16 changes the way that Leases are accounted for. In summary:

- From 1st January 2019, most leases were capitalised on the statement of financial position, and a right of use asset was recorded, along with the lease liability.
- Depreciation of the asset, and interest on the liability is accounted for in the income statement.

(ii) Prepayment features with negative compensation –Amendments to SLFRS 9

The narrow-scope amendments made to SLFRS 9 Financial Instruments which enable entities to measure certain prepayable financial assets with negative compensation at amortised cost. These assets, which include some loan and debt securities, would otherwise have to be measured at fair value through profit or loss.

To qualify for amortised cost measurement, the negative compensation must be ‘reasonable compensation for early termination of the contract’ and the asset must be held within a ‘held to collect’ business model.

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

(iii) IFRIC 23 Uncertainty over income tax treatments

The interpretation explains how to recognise and measure deferred and current income tax assets and liabilities where there is uncertainty over a tax treatment. In particular, it discusses;

- a) how to determine the appropriate unit of account, and that each uncertain tax treatment should be considered separately or together as a group, depending on which approach better predicts the resolution of the uncertainty.
- b) that the Branch should assume a tax authority will examine the uncertain tax treatments and have full knowledge of all related information, ie that detection risk should be ignored.
- c) that the Branch should reflect the effect of the uncertainty in its income tax accounting when it is not probable that the tax authorities will accept the treatment.
- d) that the impact of the uncertainty should be measured using either the most likely amount or the expected value method, depending on which method better predicts the resolution of the uncertainty, and
- e) that the judgements and estimates made must be reassessed whenever circumstances have changed or there is new information that affects the judgements.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTD)

2.1 Basis of preparation(contd)

2.1.4 Changes in accounting standards (contd)

- (a) **New accounting standards, amendments and interpretations – applicable 1 January 2019 (contd)**

(iv) **IFRIC 23 Uncertainty over income tax treatments (contd)**

There are no new disclosure requirements, but the Branch should continue following the general requirement to provide information about judgements and estimates made in preparing the financial statements.

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

(v) **Plan amendment, curtailment or settlement – Amendments to LKAS 19**

The amendments to LKAS 19 Employee benefits clarify the accounting for defined benefit plan amendments, curtailments and settlements. They confirm that the Branch must;

- a) calculate the current service cost and net interest for the remainder of the reporting period after a plan amendment, curtailment or settlement by using the updated assumptions from the date of the change.
- b) recognise any reduction in a surplus immediately in income statement, either as part of past service cost or as a gain or loss on settlement. In other words, a reduction in a surplus must be recognised in income statement even if that surplus was not previously recognised because of the impact of the asset ceiling.
- c) separately recognise any changes in the asset ceiling through other comprehensive income.

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

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTD)

2.1 Basis of preparation(contd)

2.1.4 Changes in accounting standards (contd)

(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 2019.

(i) Definition of material – Amendments to LKAS 1 and LKAS 8

The amendments to LKAS 1 Presentation of financial statements and LKAS 8 Accounting policies, Changes in accounting estimates and errors which use a consistent definition of materiality throughout International Financial Reporting Standards and the Conceptual framework for financial reporting, clarify when information is material and incorporate some of the guidance in LKAS 1 about immaterial information.

In particular, the amendments clarify;

- a) that the reference to obscuring information addresses situations in which the effect is similar to omitting or misstating that information, and that an entity assesses materiality in the context of the financial statements as a whole, and
- b) the meaning of ‘primary users of general purpose financial statements’ to whom those financial statements are directed, by defining them as ‘existing and potential investors, lenders and other creditors’ that must rely on general purpose financial statements for much of the financial information they need.

This amendment is effective for the annual periods beginning on or after 1 January 2020.

(ii) Definition of a business –Amendments to SLFRS 3

The amended definition of a business requires an acquisition to include an input and a substantive process that together significantly contribute to the ability to create outputs. The definition of the term ‘outputs’ is amended to focus on goods and services provided to customers, generating investment income and other income, and it excludes returns in the form of lower costs and other economic benefits. The amendments will likely result in more acquisitions being accounted for as asset acquisitions.

This amendment is effective for the annual periods beginning on or after 1 January 2020.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTD)

2.1 Basis of preparation(contd)

2.1.4 Changes in accounting standards (contd)

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

(ii) Revised conceptual framework for financial reporting

The revised Conceptual Framework which will be used in standard-setting decisions with immediate effect. Key changes include;

- a) increasing the prominence of stewardship in the objective of financial reporting.
- b) reinstating prudence as a component of neutrality.
- c) defining a reporting entity, which may be a legal entity, or a portion of an entity.
- d) revising the definitions of an asset and a liability.
- e) removing the probability threshold for recognition and adding guidance on derecognition
- f) adding guidance on different measurement basis, and
- g) stating that profit or loss is the primary performance indicator and that, in principle, income and expenses in other comprehensive income should be recycled where this enhances the relevance or faithful representation of the financial statements.

2.1.5 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

(i) Functional and presentation currency

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

(ii) Transactions and balances

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

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTD)

3.1 Foreign currency translation (contd)

(ii) Transactions and balances (contd)

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 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 Revenue recognition

(i) Interest

Interest income and expense is recognised in income statement using the effective interest rate (EIR) 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.

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

Interest income and expense presented in the income statement include interest on financial assets and financial liabilities measured at amortised cost calculated on an effective interest basis.

(ii) 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.

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTD)

3.2 Revenue recognition (contd)

(ii) Fees and commissions (contd)

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.

The following table provides information about the nature and timing of the satisfaction of performance obligations in contract with customers, including significant payment terms, and the related revenue recognition policies.

Types of service	Nature and timing of satisfaction of performance obligations including significant payment terms	Revenue recognition under SLFRS 15
Retail and corporate banking services	<p>The Bank provides banking services to retail and corporate customers, including account management, provision of overdraft facilities, foreign currency transactions and servicing fees.</p> <p>Fees for ongoing account management are charged to the customer's account on a monthly basis. The Bank sets the rates separately for retail and corporate banking customers in each jurisdiction on annual basis.</p> <p>Transactions based fees for interchange, foreign currency transactions and overdrafts are charged to the customer's account when the transaction takes place.</p> <p>Servicing fees are charged on a monthly basis and are based on fixed rates reviewed annually by the Bank.</p>	<p>Revenue from account service and servicing fee is recognised overtime as the services provided.</p> <p>Revenue related transactions is recognised at the point in time when the transaction takes place.</p>

3.3 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.24 of 2017 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. Current tax assets and liabilities are off-set where the Branch has a legally enforceable right to off-set and intends either to settle on asset basis, or to realise the asset and settle the liability simultaneously.

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

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTD)

3.3 Taxation (contd)

Deferred tax

Deferred tax is provided in full using the liability method on all temporary differences at the reporting date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. 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 nor loss.

Deferred tax assets are recognised for all deductible temporary differences, carry-forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and the carry-forward of unused tax credits and unused tax losses can be 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.

3.4 Leases

As explained in note 2.14 above, the Branch has changed its accounting policy for leases where the Branch is the lessee. The new policy is described in note 8(b) and the impact of the change in note 5.

Until 31 December 2018, leases in which a significant portion of the risks and rewards of ownership were not transferred to the Branch as lessee were classified as operating leases (note 18). Payments made under operating leases (net of any incentives received from the lessor) were charged to income statement on a straight-line basis over the period of the lease. Initial direct costs incurred in obtaining an operating lease were added to the carrying amount of the underlying asset and recognised as an expense over the lease term.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTD)

3.5 Financial assets and financial liabilities

3.5.1 Classification

The branch classifies its financial assets in the following measurement categories;

- Those to be measured subsequently at fair value (either through other comprehensive income (OCI) or profit or loss)
- Those to be measured at amortised cost.

The classification depends on the Branch's business model for managing the financial assets and the contractual terms on the cash flows. For assets measured at fair value, gains or losses will either be recorded in the profit or loss or OCI. The Branch reclassify debt instruments only when its business model for managing those assets changes.

3.5.2 Recognition and de-recognition

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

Derecognition - financial assets

A financial asset (or, where applicable, a part of a financial asset or part of a group of similar financial assets) is derecognised when the rights to receive cash flows from the financial asset have expired. The Company also derecognises the financial asset if it has both transferred the financial asset and the transfer qualifies for derecognition.

Derecognition - financial liabilities

A financial liability is derecognised when the obligation under the liability is discharged or cancelled or expires.

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.

3.5.3 Measurement

All financial instruments are initially recognised at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of a financial instrument on initial recognition is generally its transaction price (that is, the fair value of the consideration given or received). However, if there is a difference between the transaction price and the fair value of financial instruments whose fair value is based on a quoted price in an active market or a valuation technique that uses only data from observable markets, the branch recognises the difference as a trading gain or loss at inception (a 'day 1 gain or loss'). In case the market data is not observable, the entire day 1 gain or loss is deferred, subject to thresholds, and income is recognized when the market data becomes observable when the tenor reduces.

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTD)

3.5 Financial assets and financial liabilities (contd)

3.5.3 Measurement (contd)

The fair value of financial instruments is generally measured on an individual basis. However, in cases where the branch manages a group of financial assets and liabilities according to its net market or credit risk exposure, the fair value of the group of financial instruments is measured on a net basis but the underlying financial assets and liabilities are presented separately in the financial statements, unless they satisfy the SLFRS offsetting criteria.

The majority of valuation techniques employ only observable market data. However, certain financial instruments are classified on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the measurement of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, greater than 5% of the instrument's valuation is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used).

3.5.3.1 Financial instruments measured at amortised cost

Financial assets that are held to collect the contractual cash flows and which contain contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest are measured at amortised cost. Such financial assets include most loans and advances to branches and customers and some debt securities. In addition, most financial liabilities are measured at amortised cost.

The branch accounts for regular way amortised cost financial instruments using trade date accounting. The carrying value of these financial assets at initial recognition includes any directly attributable transactions costs. If the initial fair value is lower than the cash amount advanced, such as in the case of some leveraged finance and syndicated lending activities, the difference is deferred and recognised over the life of the loan through the recognition of interest income.

The branch may commit to underwriting loans on fixed contractual terms for specified periods of time. When the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a derivative. When the branch intends to hold the loan, the loan commitment is included in the impairment calculations set out below.

3.5.3.2 Non-trading reverse repurchase, repurchase and similar agreements

When debt securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the statement of financial position and a liability is recorded in respect of the consideration received. Securities purchased under commitments to resell ('reverse repos') are not recognised on the statement of financial position and an asset is recorded in respect of the initial consideration paid. Non-trading repos and reverse repos are measured at amortised cost. The difference between the sale and repurchase price or between the purchase and resale price is treated as interest and recognised in net interest income over the life of the agreement.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Financial assets and financial liabilities (contd)

3.5.3.2 Non-trading reverse repurchase, repurchase and similar agreements

Contracts that are economically equivalent to reverse repo or repo agreements (such as sales or purchases of debt securities entered into together with total return swaps with the same counterparty) are accounted for similarly to, and presented together with, reverse repo or repo agreements.

3.5.3.3 Financial assets measured at fair value through other comprehensive income

Financial assets held for a business model that is achieved by both collecting contractual cash flows and selling and which contain contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest are measured at fair value through other comprehensive income ('FVOCI'). These comprise primarily debt securities. They are recognised on the trade date when HSBC enters into contractual arrangements to purchase and are normally derecognised when they are either sold or redeemed. They are subsequently remeasured at fair value and changes therein (except for those relating to impairment, interest income and foreign currency exchange gains and losses) are recognised in other comprehensive income until the assets are sold. Upon disposal, the cumulative gains or losses in other comprehensive income are recognised in the income statement as 'Gains or losses' from financial instruments. Financial assets measured at FVOCI are included in the impairment calculations set out below in note 22.2 and impairment is recognised through Fair Value through Other Comprehensive Income (FVOCI) reserve.

3.5.3.4 Financial instruments designated at fair value through profit or loss

Financial instruments, which are held as part of held for trading category get designated at Fair value through P&L. Currently these instruments are LKR denominated T-bills and Government bonds held by Global Markets business for market making. These instruments get revalued on daily basis based on the market levels observed for the instruments. The market to market movement will then flow through profit or loss.

3.5.3.5 Derivatives

Derivatives are financial instruments that derive their value from the price of underlying items such as equities, interest rates or other indices. Derivatives are recognized initially and are subsequently measured at fair value through profit or loss. Derivatives are classified as assets when their fair value is positive or as liabilities when their fair value is negative.

3.5.3.6 Equity instruments

The branch subsequently measures all the equity instruments at fair value, where the Branch's management has elected to present fair value gains and losses on equity investments in OCI, there is no subsequent reclassification at fair value gains and losses to income statement following the derecognition of the investment. Dividends from such investments continue to be recognised in income statement as other income when the Branch's right to receive is established. Changes in the fair value of financial assets at FVPL are recognised in other gains or losses in the income statement as applicable. Impairment losses (and reversal of impairment losses) on equity investments measured at FVOCI are not reported separately from other changes in fair value.

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5.4 Impairment of amortised cost and FVOCI financial assets

Expected credit losses ('ECL') are recognised for loans and advances to branches and customers, non-trading reverse repurchase agreements, other financial assets held at amortised cost, debt instruments measured at FVOCI, and certain loan commitments and financial guarantee contracts. At initial recognition, allowance (or provision in the case of some loan commitments and financial guarantees) is required for ECL resulting from default events that are possible within the next 12 months, or less, where the remaining life is less than 12 months ('12-month ECL'). In the event of a significant increase in credit risk, allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL'). Financial assets where 12-month ECL is recognised are considered to be 'stage 1'; financial assets that are considered to have experienced a significant increase in credit risk are in 'stage 2'; and financial assets for which there is objective evidence of impairment so are considered to be in default or otherwise credit impaired are in 'stage 3'. Purchased or originated credit-impaired financial assets ('POCI') are treated differently.

3.5.5 Assigned capital

Assigned capital of the bank represent the capital contributions made to the Branch by the Head office. The increase in equity on the receipt of capital contributions is normally recorded as the residual after recording the recognition or de-recognition of assets or liabilities arising on the share issue (the proceeds of issue) and after deducting directly attributable transaction costs.

Distributions to holders of equity, which include profits transferred to head office are debited directly to equity at the date of payment.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.6 Assets and bases of their valuation

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 500 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
Furnitures 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.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.7 Export bills negotiated and discounted

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

3.8 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. Cash and cash equivalents include notes and coins on hand, unrestricted balances held with central bank, and highly liquid financial assets with original maturities of three months or less from the date of the acquisition that are subject to and insignificant risk of changes in their fair value, and are used by the bank in the management of its short term commitments.

3.9 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 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 policies.

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.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.10 Employee share plans (contd)

3.10.1 Discretionary awards (contd)

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

3.11 Financial guarantees

In the ordinary course of business, the Bank gives financial guarantees, consisting letter of credit, guarantees and acceptances. Financial guarantees are initially recognised in the financial statements (within “other liabilities”) at fair value, being the premium received. Subsequent to the initial recognition, the Branch’s liability under each guarantee is measured at the higher of the amount initially recognised less cumulative amortisation recognised in the income statement and the best estimate of expenditure required to settle any financial obligations arising as a result of guarantees. Any increase in the liability relating to financial guarantee is recorded in the income statement in “impairment charge”. The premium received is recognised in the income statement in “fees and commission income” on a straight-line basis over the life of the guarantee.

3.12 Employee benefits

3.12.1 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 HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.12 Employee benefits (contd)

3.12.1 Pension fund (contd)

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.

3.12.2 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.

3.12.3 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.

3.13 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.

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.14 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.

3.15 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.

3.16 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.

3.17 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.

3.18 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.

3.19 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 equivalents comprise mainly of cash on 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.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.20 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.

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, Crop Levy and Debt Repayment 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 size of bid / offer spreads. The bid / offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. Valuation techniques may incorporate assumptions about factors that other market participants would use in their valuations, including;

- the likelihood and expected timing of future cash flows on the instrument. Judgement may be required to assess the counterparty's ability to service the instrument in accordance with its contractual terms. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. Judgement is required to assess what a market participant would regard as the appropriate spread of the rate for an instrument over the appropriate risk-free rate; and
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing derivative products.

A range of valuation techniques is employed, dependent on the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analyses, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to considering credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. 'Projection' utilises market forward curves, if available. In 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.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

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

Credit impaired (stage 3)

HSBC determines that a financial instrument is credit impaired and in stage 3 by considering relevant objective evidence, primarily whether;

- contractual payments of either principal or interest are past due for more than 90 days;
- there are other indications that the borrower is unlikely to pay, such as when a concession has been granted to the borrower for economic or legal reasons relating to the borrower's financial condition; and
- the loan is otherwise considered to be in default.

If such unlikeliness to pay is not identified at an earlier stage, it is deemed to occur when an exposure is 90 days past due. Therefore stage 3 represents all loans that are considered defaulted or otherwise credit impaired.

Write-off

Financial assets (and the related impairment allowances) 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 realisation of security. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write-off may be earlier.

Renegotiation

Loans are identified as renegotiated and classified as credit impaired when we modify the contractual payment terms due to significant credit distress of the borrower. Renegotiated loans remain classified as credit impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows and retain the designation of renegotiated until maturity or de-recognition. For retail, renegotiated loans are kept at stage 3 until full settlement

4. SIGNIFICANT MANAGEMENT ESTIMATES AND JUDGEMENTS (CONTINUED)

Renegotiation

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement is made on substantially different terms, or if the terms of an existing agreement are modified such that the renegotiated loan is a substantially different financial instrument. Any new loans that arise following de-recognition events in these circumstances are considered to be POCI and will continue to be disclosed as renegotiated loans.

Other than originated credit-impaired loans, all other modified loans could be transferred out of stage 3 if they no longer exhibit any evidence of being credit impaired and, in the case of renegotiated loans, there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows over the minimum observation period, and there are no other indicators of impairment. These loans could be transferred to stage 1 or 2 based on the mechanism as described below by comparing the risk of a default occurring at the reporting date (based on the modified contractual terms) and the risk of a default occurring at initial recognition (based on the original, unmodified contractual terms). Any amount written off as a result of the modification of contractual terms would not be reversed.

Loan modifications that are not credit impaired

Loan modifications that are not identified as renegotiated are considered to be commercial restructuring.

Significant increase in credit risk (stage 2)

An assessment of whether credit risk has increased significantly since initial recognition is performed at each reporting period by considering the change in the risk of default occurring over the remaining life of the financial instrument. The assessment explicitly or implicitly compares the risk of default occurring at the reporting date compared with that at initial recognition, taking into account reasonable and supportable information, including information about past events, current conditions and future economic conditions. The assessment is unbiased, probability-weighted, and to the extent relevant, uses forward-looking information consistent with that used in the measurement of ECL. The analysis of credit risk is multifactor. The determination of whether a specific factor is relevant and its weight compared with other factors depends on the type of product, the characteristics of the financial instrument and the borrower, and the geographical region. Therefore, it is not possible to provide a single set of criteria that will determine what is considered to be a significant increase in credit risk, and these criteria will differ for different types of lending, particularly between retail and wholesale.

However, unless identified at an earlier stage, all financial assets are deemed to have suffered a significant increase in credit risk when 30 days past due and 01 day past due in Retail. In addition, wholesale loans that are individually assessed, typically corporate and commercial customers, and included on a watch or worry list, are included in stage 2.

For wholesale portfolios, the quantitative comparison assesses default risk using a lifetime probability of default ('PD') which encompasses a wide range of information including the obligor's customer risk rating ('CRR'), macroeconomic condition forecasts and credit transition probabilities.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

4. SIGNIFICANT MANAGEMENT ESTIMATES AND JUDGEMENTS (CONTINUED)

Unimpaired and without significant increase in credit risk – (stage 1)

ECL resulting from default events that are possible within the next 12 months (12-month ECL) are recognised for financial instruments that remain in stage 1.

5. CHANGES IN ACCOUNTING POLICIES

As indicated above in note 2.1.4, the Branch has adopted SLFRS 16 Leases retrospectively from 1 January 2019, but has not restated comparatives for the 2018 reporting period, as permitted under the specific transition provisions in the standard. The reclassifications and the adjustments arising from the new leasing rules are therefore recognised in the opening statement of financial position on 1 January 2019.

On adoption of SLFRS 16, the Branch recognised lease liabilities in relation to leases which had previously been classified as ‘operating leases’ under the principles of IAS 17 Leases. These liabilities were measured at the present value of the remaining lease payments, discounted using the lessee’s incremental borrowing rate as of 1 January 2019.

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

FOR THE YEAR ENDED 31 DECEMBER

6	Net interest income	2019	2018
		Rs.'000	Rs.'000
	Interest income		
	Cash and cash equivalents	-	-
	Balances with central banks	13,831	5,082
	Placements with banks	191,683	154,612
	Derivative financial instruments	-	-
	Financial assets recognized through profit or loss	-	-
	- measured at fair value	711,763	947,720
	- designated fair value	-	-
	Financial assets at amortised cost	-	-
	- loans and advances	20,208,556	17,860,315
	- debt and other instruments	492,279	598,830
	Financial assets measured at fair value through other comprehensive income	8,560,483	9,423,764
	Interest income from intercompany entities	896,258	667,065
	Others	-	-
	Total interest income	31,074,853	29,657,388
	Interest expenses		
	Due to banks	(97,192)	(414,783)
	Derivative financial instruments	-	-
	Financial liabilities recognized through profit or loss	-	-
	- measured at fair value	-	-
	- designated fair value	-	-
	Financial liabilities at amortised cost	-	-
	- due to depositors	(7,837,689)	(6,801,803)
	- due to debt securities holders	(310,047)	(376,263)
	- due to other borrowers	-	-
	Others	(4,124,307)	(3,618,900)
	- Interest expense on lease liabilities	(71,905)	-
	Total interest expenses	(12,441,140)	(11,211,749)
		18,633,713	18,445,639
6.1	Net interest income from Sri Lanka Government Securities		
	Interest income	9,764,525	10,970,314

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

FOR THE YEAR ENDED 31 DECEMBER

7	Net fee and commission income	2019	2018
		Rs.'000	Rs.'000
	Fee and commission income	4,232,795	4,046,719
	Fee and commission expenses	(1,279,789)	(1,006,278)
		<u>2,953,006</u>	<u>3,040,441</u>
7.1	Comprising		
	Loans and advances	75,597	117,496
	Credit cards	1,672,012	1,694,345
	Trade and remittance transactions	1,165,577	1,054,389
	Deposits accounts	108,545	109,332
	Trustee and fiduciary services	106,044	196,222
	Others	(174,769)	(131,343)
	Net fee and commission income	<u>2,953,006</u>	<u>3,040,441</u>
8	Net gain from trading	2019	2018
		Rs.'000	Rs.'000
	Foreign exchange (excluding derivatives)		
	- Losses from transaction with customers	(1,384,478)	(519,248)
	- Gains from transaction with others	2,459,506	2,277,427
	Fixed income securities	291,838	18,130
	Derivative financial instruments	(7)	78
		<u>1,366,859</u>	<u>1,776,387</u>

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

FOR THE YEAR ENDED 31 DECEMBER

9	Net fair value gains from financial instruments at fair value through profit or loss	2019	2018
		Rs.'000	Rs.'000
	Gains on financial assets at fair value through profit or loss	379,949	312,260
10	Other operating income (net)	2019	2018
		Rs.'000	Rs.'000
	(Loss) / profit on sale of property, plant and equipment	(436)	17,614
	Others	43,057	42,630
		42,621	60,244
11	Impairment charges / (reversals) for loans and other losses	2019	2018
		Rs.'000	Rs.'000
11.1	Financial assets at amortised cost - loans and advances (Note 21.2)		
	Stage 1	(144,425)	10,093
	Stage 2	(91,287)	(283,450)
	Stage 3	(180,259)	173,343
		(415,971)	(100,014)
11.2	Financial assets at amortised cost – debt instruments (Note 23.b)		
	Stage 1	(368)	11,971
		(368)	11,971
11.3	Financial assets measured at fair value through other comprehensive income (Note 22.b)		
	Stage 1	116,910	(138,635)
		116,910	(138,635)
11.4	Contingent liabilities and commitments (Note 38.2)		
	Stage 1	(40,636)	26,802
	Stage 2	26,976	626
	Stage 3	(2,716)	6,360
		(16,376)	33,788
11.5	Others		
	Stage 1	(5,229)	7,794
	Stage 2	(45)	91
	Stage 3	-	-
	Other (Write-off's, recoveries and recovery of assets)	1,131,556	353,852
		1,126,282	361,737
		810,477	168,847

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

FOR THE YEAR ENDED 31 DECEMBER

12 Personnel expenses	2019	2018
	Rs.'000	Rs.'000
Salary and bonus	(2,716,073)	(2,650,559)
Contributions to defined contribution / benefit plans	(164,347)	(154,506)
Provision for defined benefit obligation	(1,493)	(14,858)
Others	(1,136,976)	(1,032,781)
	<u>(4,018,889)</u>	<u>(3,852,704)</u>
13 Other expenses	2019	2018
	Rs.'000	Rs.'000
Auditors' remunerations	(4,849)	(4,306)
Non-audit fees to auditors	(9,464)	(5,726)
Professional and legal expenses	(38,133)	(56,642)
Depreciation of property, plant and equipment	(327,131)	(300,142)
Depreciation-Short leasehold and buildings	(233,753)	-
Office administration and establishment expenses	(2,822,976)	(2,451,969)
Others	(5,007,909)	(4,617,592)
Short-term lease expenses	(53,699)	-
	<u>(8,497,914)</u>	<u>(7,436,378)</u>

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

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

FOR THE YEAR ENDED 31 DECEMBER

14 Tax expense	2019	2018
	Rs.'000	Rs.'000
14.1 Current tax expense		
Current tax on profit for the year (Note 14.3)	(2,657,345)	(3,989,625)
Over provision for the previous year	633,254	484,959
Tax of prior years paid in current year	(8,900)	(99,942)
Remittance tax	(113,976)	(213,000)
	<u>(2,146,967)</u>	<u>(3,817,608)</u>
Deferred tax expenses		
-Provision for employee benefit	5,601	-
- Owned assets	2,912	(62,016)
-Allowance for loans losses	38,488	(61,078)
-SLFRS 16	16,050	-
-Depreciation on revaluation of land & building	1,917	-
Deferred tax assets recognised / (reversed) during the year	<u>64,968</u>	<u>(123,094)</u>
- Provision for employee benefit	-	3,719
- Depreciation on revaluation of land & building	-	1,544
Deferred tax liabilities recognized during the year	<u>-</u>	<u>5,263</u>
	<u>64,968</u>	<u>(117,831)</u>
Total tax charge to income statement	<u>(2,081,999)</u>	<u>(3,935,439)</u>
14.2 Tax charge to the statement of other comprehensive income		
-Provision for employee benefit	36,971	(19,492)
-FVOCI reserve	(371,027)	463,490
-Revaluation of buildings	35,395	(832,595)
	<u>(298,661)</u>	<u>(388,597)</u>
14.3 Reconciliation between tax expense and accounting profit		
Accounting profit before taxation	8,325,536	10,056,943
Income tax for the period at 28%	2,331,150	2,815,944
Add: Tax effect of expenses that are not deductible for tax purposes	838,561	1,729,962
Less: Tax effect of expenses that are deductible for tax purposes	(168,961)	(555,361)
Tax effect on exempt Income	(343,405)	(920)
Current tax on profit for the year	<u>2,657,345</u>	<u>3,989,625</u>
14.4 Breakdown of Value added tax and Nation Building tax		
Value Added Tax	(1,525,846)	(1,862,194)
Nation Building Tax	(197,443)	(257,845)
	<u>(1,723,289)</u>	<u>(2,120,039)</u>

- During the 12 months period ended December 2019 the applicable Value Added Tax (VAT) rate has been at 8%.

- Nation Building Tax (NBT) rate has been 2% for the eleven months ending November 2019 and NBT has been abolished with effect from 1 December 2019.

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

AS AT 31 DECEMBER

15 Analysis of financial instruments by measurement basis

15.1 As at 31 December 2019

	Fair value through profit or loss	Amortized cost	Fair value through other comprehensive income	Total
	Rs.'000	Rs.'000	Rs.'000	Rs.'000
ASSETS				
Cash and cash equivalents	-	33,986,285	-	33,986,285
Balances with the Central Bank of Sri Lanka	-	9,740,145	-	9,740,145
Placements with banks	-	27,214,500	-	27,214,500
Derivative financial instruments	812,121	-	-	812,121
Financial assets measured at fair value through profit or loss	4,751,028	-	-	4,751,028
Financial assets at amortised cost – loans and advances	-	260,155,127	-	260,155,127
Financial assets measured at fair value through other comprehensive income	-	-	107,854,554	107,854,554
Financial assets at amortised cost - debt instruments	-	3,088,314	-	3,088,314
Acceptances and endorsements	-	6,349,354	-	6,349,354
Total financial assets	5,563,149	340,533,725	107,854,554	453,951,428
LIABILITIES				
Due to banks	-	170,599,897	-	170,599,897
Derivative financial instruments	1,052,576	-	-	1,052,576
Financial liabilities at amortised cost - due to depositors	-	209,805,122	-	209,805,122
Acceptances and endorsements	-	6,349,354	-	6,349,354
Total financial liabilities	1,052,576	386,754,373	-	387,806,949

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

AS AT 31 DECEMBER

15 Analysis of financial instruments by measurement basis (contd)

15.2 As At 31 December 2018

	Fair value through profit or loss	Amortized cost	Fair value through other comprehensive income	Total
	Rs.'000	Rs.'000	Rs.'000	Rs.'000
ASSETS				
Cash and cash equivalents	-	23,502,316	-	23,502,316
Balances with Central Bank	-	7,332,880	-	7,332,880
Placements with banks	-	49,385,700	-	49,385,700
Derivative financial instruments	4,466,754	-	-	4,466,754
Financial assets measured at fair value through profit or loss	11,516,593	-	-	11,516,593
Financial Assets at Amortised Cost – Loans and Advances	-	255,830,603	-	255,830,603
Financial assets measured at fair value through other comprehensive income	-	-	100,949,137	100,949,137
Financial Assets at Amortised Cost – Loans and Advances	-	5,308,259	-	5,308,259
Acceptances and endorsements	-	6,843,206	-	6,843,206
Total financial assets	15,983,347	348,202,964	100,949,137	465,135,448
LIABILITIES				
Due to banks	-	184,786,888	-	184,786,888
Derivative financial instruments	3,875,848	-	-	3,875,848
Financial liabilities at amortised cost - due to depositors	-	205,873,323	-	205,873,323
Acceptances and endorsements	-	6,843,206	-	6,843,206
Total financial liabilities	3,875,848	397,503,417	-	401,379,265

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

AS AT 31 DECEMBER

16	Cash and cash equivalents	2019	2018
		Rs.'000	Rs.'000
	Cash in hand	1,177,287	1,543,232
	Balances with other banks	32,808,998	21,959,084
		<u>33,986,285</u>	<u>23,502,316</u>
17	Balances with the Central Bank of Sri Lanka	2019	2018
		Rs.'000	Rs.'000
	Statutory balances with Central bank of Sri Lanka	7,940,145	7,332,880
	Non-statutory balances with central banks		
	- Placements with Central bank of Sri Lanka*	1,800,000	-
		<u>9,740,145</u>	<u>7,332,880</u>
	<p>- 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 5.0% as at 31st December 2019 (2018 : 6%).</p> <p>- Placement with Central bank of Sri Lanka is an overnight balance held as at 31 December 2019.</p>		
18	Placements with banks	2019	2018
		Rs.'000	Rs.'000
	Placements	27,214,500	49,385,700
		<u>27,214,500</u>	<u>49,385,700</u>
19	Derivative financial instruments	2019	2018
		Rs.'000	Rs.'000
	Interest rate derivatives		
	Interest rate swaps	-	13,693
	Forward foreign exchange contracts	812,121	4,453,061
		<u>812,121</u>	<u>4,466,754</u>
20	Financial assets measured at fair value through profit or loss	2019	2018
		Rs.'000	Rs.'000
	Treasury bills	1,347,288	950,871
	Treasury bonds	3,403,740	10,565,722
		<u>4,751,028</u>	<u>11,516,593</u>
20.1	Analysis		
	By collateralisation		
	- Unencumbered	4,751,028	11,516,593
	By currency		
	- Sri Lankan rupee	4,751,028	11,516,593

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

AS AT 31 DECEMBER

21 Financial assets at amortised cost – Loans and advances

	Note	2019 Rs.'000	2018 Rs.'000
Gross loans and advances			
Stage 1		238,508,685	237,628,433
Stage 2		22,606,685	19,584,012
Stage 3		746,794	770,344
	21.1	<u>261,862,164</u>	<u>257,982,789</u>
Less: Accumulated impairment under			
Stage 1		(661,284)	(817,352)
Stage 2		(507,521)	(610,453)
Stage 3		(538,232)	(724,381)
	21.2	<u>(1,707,037)</u>	<u>(2,152,186)</u>
Net loans and receivables		<u><u>260,155,127</u></u>	<u><u>255,830,603</u></u>

21.1 Analysis

21.1.1 By product

Overdrafts		36,910,890	35,859,299
Trade finance		41,263,555	51,733,563
Credit cards		26,037,785	24,428,098
Staff loans		1,852,073	1,869,720
Term loans		155,797,861	144,092,108
Term loans - short term		27,570,098	22,687,007
Term loans - long term		127,473,969	120,494,378
Mortgages		753,794	910,724
Gross total		<u><u>261,862,164</u></u>	<u><u>257,982,789</u></u>

21.1.2 By currency

Sri Lankan Rupee		94,419,969	86,853,321
United States Dollar		162,686,358	166,876,051
Great Britain Pound		287,652	-
Others		4,468,185	4,253,417
Gross total		<u><u>261,862,164</u></u>	<u><u>257,982,789</u></u>

21.1.3 By industry

Agriculture and fishing		4,266,765	4,515,815
Manufacturing		92,909,048	80,759,461
Tourism		45,801,600	37,999,229
Transport		13,488,453	15,830,302
Construction		7,610,966	5,724,129
Traders		23,442,555	30,151,021
New economy		9,870,985	10,728,457
Others		64,471,792	72,274,375
Gross total		<u><u>261,862,164</u></u>	<u><u>257,982,789</u></u>

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

AS AT 31 DECEMBER

21	Financial assets at amortised cost – Loans and advances (contd)		
21.2	Provision for impairment loss	2019	2018
		Rs.'000	Rs.'000
21.2.1	Stage 1		
	Opening balance as at 01 January	817,352	719,498
	Charge to income statement	(144,425)	10,093
	Exchange fluctuations and other movements	(11,643)	87,761
	Closing balance as at 31 December	<u>661,284</u>	<u>817,352</u>
21.2.2	Stage 2		
	Opening balance as at 01 January	610,453	847,631
	Charge to income statement	(91,287)	(283,450)
	Exchange fluctuations and other movements	(11,645)	46,272
	Closing balance as at 31 December	<u>507,521</u>	<u>610,453</u>
21.2.3	Stage 3		
	Opening balance as at 01 January	724,381	562,801
	Charge to income statement	(180,259)	173,343
	Exchange fluctuations and other movements	(5,890)	(11,763)
	Closing balance as at 31 December	<u>538,232</u>	<u>724,381</u>
22	Financial assets measured at fair value through other comprehensive income	2019	2018
		Rs.'000	Rs.'000
	Treasury bills	36,249,632	1,859,948
	Treasury bonds	71,604,922	99,089,189
		<u>107,854,554</u>	<u>100,949,137</u>
22.1	Analysis		
	By collateralisation		
	- Pledged as collateral	4,263,268	8,633,157
	- Unencumbered	103,591,286	92,315,980
		<u>107,854,554</u>	<u>100,949,137</u>
	By Currency		
	- Sri Lankan Rupees	76,080,599	54,209,332
	- United States Dollar	31,773,955	46,739,805
		<u>107,854,554</u>	<u>100,949,137</u>
		2019	2018
		Rs.'000	Rs.'000
22.2	Movements in provision for impairment loss during the year		
	Opening balance	184,810	309,508
	Impairment classification	116,910	(138,635)
	Exchange fluctuations and other movements	665	13,937
	Closing balance	<u>302,385</u>	<u>184,810</u>

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22	Financial assets measured at fair value through other comprehensive income (contd)	2019	2018
		Rs.'000	Rs.'000
22.3	Securities pledged against repurchase agreements		
	Repo value	4,000,000	8,686,934
	Fair value of securities held	4,263,268	8,697,504
23	Financial assets at amortised cost - debt instruments	2019	2018
		Rs.'000	Rs.'000
	Treasury bonds	3,099,917	5,320,230
	Accumulated impairment	(11,603)	(11,971)
		<u>3,088,314</u>	<u>5,308,259</u>
23.1	Financial assets at amortised cost - debt instruments		
	By collateralisation		
	- Unencumbered	3,099,917	5,320,230
	By currency		
	- Sri Lankan Rupee	3,099,917	5,320,230
23.2	Movements in impairment during the year	2019	2018
	Stage 1	Rs.'000	Rs.'000
	Opening balance as at 01 January	11,971	-
	(Write back) / charge to income statement	(368)	11,971
	Closing balance as at 31 December	<u>11,603</u>	<u>11,971</u>

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24 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 vehicles	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 2018	2,105,633	1,368,116	754,196	16,907	180,817	666,083	164,244	-	5,255,996
Additions during the year	11,441	-	89,984	-	117,347	62,604	-	-	281,376
Disposals during the year	-	-	(5,437)	-	-	(646)	(45,703)	-	(51,786)
Revaluation gain	694,032	66,785	-	-	-	-	-	-	760,817
Closing balance as at 31 December 2018	<u>2,811,106</u>	<u>1,434,901</u>	<u>838,743</u>	<u>16,907</u>	<u>298,164</u>	<u>728,041</u>	<u>118,541</u>	<u>-</u>	<u>6,246,403</u>
Balance as at 1 January 2019	2,811,106	1,434,901	838,743	16,907	298,164	728,041	118,541	-	6,246,403
Additions during the year	-	78,273	463,341	-	-	67,972	-	266,940	876,526
Disposals during the year	-	-	(40,767)	(697)	(76,838)	(218,299)	-	-	(336,601)
Transfers during the year	-	219,164	62,714	-	(62,714)	-	-	(219,164)	-
Revaluation (loss) / gain	(38,502)	(202,536)	-	-	-	-	-	-	(241,038)
Adjustments	(11,441)	11,441	-	-	-	-	-	-	-
Balance as at 31st December 2019	<u>2,761,163</u>	<u>1,541,243</u>	<u>1,324,031</u>	<u>16,210</u>	<u>158,612</u>	<u>577,714</u>	<u>118,541</u>	<u>47,776</u>	<u>6,545,290</u>
Accumulated depreciation									
Balance as at 1 January 2018	-	-	473,187	15,607	165,507	507,505	153,447	-	1,315,253
Charge for the year	-	(112,915)	103,678	346	12,187	65,785	5,680	-	74,761
Revaluation adjustment	-	112,915	-	-	-	-	-	-	112,915
Disposals during the year	-	-	(6)	-	-	(646)	(45,704)	-	(46,356)
Balance as at 31 December 2018	<u>-</u>	<u>-</u>	<u>576,859</u>	<u>15,953</u>	<u>177,694</u>	<u>572,644</u>	<u>113,423</u>	<u>-</u>	<u>1,456,573</u>
Balance as at 1 January 2019	-	-	576,859	15,953	177,694	572,644	113,423	-	1,456,573
Charge for the year	-	(114,810)	116,825	318	17,463	72,149	4,725	-	96,670
Reclassified during the year	-	-	8,362	-	(8,362)	-	-	-	-
Revaluation adjustment	-	114,810	-	-	-	-	-	-	114,810
Disposals during the year	-	-	(39,999)	(697)	(76,838)	(218,065)	-	-	(335,599)
Balance as at 31 December 2019	<u>-</u>	<u>-</u>	<u>662,047</u>	<u>15,574</u>	<u>109,957</u>	<u>426,728</u>	<u>118,148</u>	<u>-</u>	<u>1,332,454</u>
Carrying value	2,761,163	1,541,243	661,984	636	48,655	150,986	393	47,776	5,212,836
As at 31 December 2018	2,811,106	1,434,901	261,884	954	120,470	155,397	5,118	-	4,789,830
As at 31 December 2019	2,761,163	1,541,243	661,984	636	48,655	150,986	393	47,776	5,212,836

a) As at 31 December 2019, property plant and equipment include fully depreciated assets of amounting to Rs 826,669,525 (2018 - Rs 938,763,591) which are still in use.

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

	Land		Buildings	
	2019 Rs.	2018 Rs.	2019 Rs.	2018 Rs.
Cost	4,970,000	4,970,000	1,438,930,088	1,103,848,410
Accumulated depreciation	-	-	(513,547,078)	(405,766,603)
Net book amount as at 31 December	4,970,000	4,970,000	925,383,010	698,081,807

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25 Property, plant and equipment (contd)

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

The land and buildings of the Branch as at 31 December 2019 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 independent 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 - higher 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	Sale price per perch Cost spent	Direct correlation - higher the cost spent, higher the market value

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26	Deferred tax (liabilities) / assets	2019	2018
		Rs.'000	Rs.'000
	Deferred tax assets	855,202	932,387
	Deferred tax liabilities	(1,221,625)	(1,065,117)
		(366,423)	(132,730)

26.1 Temporary differences

Deferred tax assets and liabilities are attributable to the following:

	2019		2018	
	Temporary difference	Tax effects	Temporary difference	Tax effects
	Rs. '000	Rs.'000	Rs.'000	Rs.'000
Deferred tax assets on ;				
Provision for retirement benefit obligation	953,896	267,091	801,854	224,519
Allowance for loan losses IFRS 16	2,043,074	572,061	1,905,616	533,573
	57,322	16,050		
Other comprehensive income reserve	-	-	622,482	174,295
	3,054,292	855,202	3,329,952	932,387
Deferred tax liabilities on ;				
Property revaluation reserve	(3,419,562)	(957,477)	(3,552,819)	(994,789)
Accelerated depreciation for tax: -				
Owned assets	(240,767)	(67,415)	(251,168)	(70,328)
Other comprehensive income reserve	(702,614)	(196,733)	-	-
	(4,362,943)	(1,221,625)	(3,803,987)	(1,065,117)
Net liabilities as at 31 December	(1,308,651)	(366,423)	(474,035)	(132,730)

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

27	Other assets	2019	2018
		Rs.'000	Rs.'000
	Receivables	4,218,425	4,340,536
	Deposits and prepayments	161,578	242,967
	Sundry debtors	-	1,308
	Acceptances and endorsements	6,349,354	6,843,206
	Right-of-use assets (Note 27.1)	1,891,998	-
	Others	1,896,116	2,929,765
		14,517,471	14,357,782

27.1 Right-of-use assets and lease liabilities

27.1.1	Amounts recognised in the balance sheet	2019
		Rs.'000
	Right-of-use assets - Buildings	1,896,116
	Lease liabilities	634,998

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AS AT 31 DECEMBER

27 Other assets (contd)

2019
Rs.'000

27.1 Right-of-use assets and lease liabilities (contd)

27.1.2 Amounts recognised in the statement of profit or loss

Depreciation charges	233,753
Interest expense (included in finance cost)	71,905
Expense relating to short-term leases (included in cost of goods sold and administrative expenses)	53,699

27.1.3 The group's leasing activities and how these are accounted for;

The Bank leases various offices throughout the country. Majority of the lease contracts are with an option of extension as explained below in note 27.1.5.

Contracts may contain both lease and non-lease components. The Bank allocates the consideration in the contract to the lease and non-lease components based on their relative stand-alone prices. However, for leases of real estate for which the Bank is a lessee, it has elected not to separate lease and non-lease components and instead accounts for these as a single lease component.

Lease terms are negotiated on an individual basis and contain a wide range of different terms and conditions. The lease agreements do not impose any covenants other than the security interests in the leased assets that are held by the lessor. Leased assets may not be used as security for borrowings.

Until the 2018 financial year, leases of property, plant and equipment were classified as operating leases. From 1 January 2019, leases are recognised as a right-of-use asset and a corresponding liability at the date at which the leased asset is available for use by the Bank.

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

- * fixed payments (including in-substance fixed payments), less any lease incentives receivable
- * amounts expected to be payable by the Bank under residual value guarantees
- * the exercise price of a purchase option if the Bank is reasonably certain to exercise that option, and
- * payments of penalties for terminating the lease, if the lease term reflects the Bank exercising that option.

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

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

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27 Other assets (contd)

27.1 Right-of-use assets and lease liabilities (contd)

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

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

Right-of-use assets are generally depreciated over the shorter of the asset's useful life and the lease term on a straight-line basis. While the Bank revalues its land and buildings that are presented within property, plant and equipment, it has chosen not to do so for the right-of-use buildings held by the Bank.

Payments associated with short-term leases are recognised on a straight-line basis as an expense in profit or loss. Short-term leases are leases with a lease term of 12 months or less.

27.1.5 Extension and termination options

Extension and termination options are included in a number of property and equipment leases across the Bank. These are used to maximise operational flexibility in terms of managing the assets used in the Bank's operations. The majority of extension and termination options held are exercisable only by the Bank and not by the respective lessor.

Only property leases are managed by the Branch. Both parties (Landlord and the Branch) have the right to exercise the Termination option in most of the leases and for renewal , the Bank needs to inform the Landlord as per agreed lease conditions if the Bank wish to renew the lease . However as per the renewal Lease options incorporated to all leases the terms and conditions for the extended (renewal) period are subject to mutual consent at the time of the renewal and are not specified in the current leases in force.

28 Due to banks	2019	2018
	Rs.'000	Rs.'000
Borrowings	157,105,844	157,185,930
Securities sold under repurchase (repo) agreements	4,000,000	8,686,934
Others	9,494,053	18,914,024
	<u>170,599,897</u>	<u>184,786,888</u>

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29 Derivative financial instruments	2019	2018
	Rs.'000	Rs.'000
Interest rate derivatives	-	13,686
Forward foreign exchange contracts	1,052,576	3,862,162
	1,052,576	3,875,848
30 Financial liabilities at amortised cost - due to depositors		
Total amount due to other customers (Note 30.1)	209,805,122	205,873,323
	209,805,122	205,873,323
30.1 Analysis		
30.1.1 By product		
Demand deposits (current accounts)	55,479,928	70,067,868
Savings deposits	47,927,300	40,303,962
Fixed deposits	100,737,985	90,006,030
Other deposits	5,659,909	5,495,463
Total	209,805,122	205,873,323
30.1.2 By currency		
Sri Lankan Rupees	116,462,080	102,614,349
United States Dollar	78,662,753	88,008,708
Great Britain Pound	6,276,805	6,244,241
Others	8,403,484	9,006,025
Total	209,805,122	205,873,323
31 Defined benefit liability - net		
Present value of defined benefit obligations (Note 31.1)	953,896	801,854
Fair value of plan assets (Note 31.2)	(874,683)	(778,849)
	79,213	23,005
31.1 Movement in the present value of defined benefit obligations		
Opening balance	801,854	858,185
Current service cost	3,754	6,189
Interest cost	90,758	85,289
Benefits paid during the year	(74,509)	(78,196)
Actuarial gain for the year	132,039	(69,613)
Closing balance	953,896	801,854
31.2 Movement in fair value of plan assets		
Opening balance	778,849	732,827
Expected return on plan assets	93,018	76,621
Contribution by employers	70,000	84,000
Benefits paid during the year	(74,509)	(78,196)
Actuarial gain / (loss) or loss for the year	7,325	(36,403)
Closing balance	874,683	778,849

Plan assets are invested in government treasury securities, that are measured at fair value through profit or loss.

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31 Defined benefit liability - net (contd)

31.3 Sensitivity analysis of the defined benefit obligation

	2019	2018
	Rs.'000	Rs.'000
a. Discount rate		
Discount rate	10.10%	11.90%
1. Effect due to the increase in the discount rate by 1.00% (Rs '000)	(84,653)	(61,951)
2. Effect due to the decrease in the discount rate by 1.00% (Rs '000)	103,005	73,431
b. Increase in salary escalation rate and post retirement pension		
Salary escalation rate		
- Union members	5%	10%
- Non-union members	5%	5%
Post retirement pension	3.5%	4.0%
1. Effect on DBO due to an increase in the salary escalation and post retirement pension rate by 1% p.a. (Rs '000)	87,224	67,070
2. Effect on DBO due to a decrease in the salary escalation and post retirement pension rate by 1% p.a. (Rs '000)	(75,550)	(58,576)
Weighted average duration of defined benefit obligation	9.2 years	10.6 years

32 Other liabilities

	2019	2018
	Rs.'000	Rs.'000
Sundry creditors	446,884	955,143
Interest payable	7,441,758	5,628,882
Acceptances and endorsements	6,349,354	6,843,206
Impairment in respect of off-balance sheet credit exposures	63,524	77,348
Lease liabilities	634,998	-
Other payables	3,508,588	7,642,373
	<u>18,445,106</u>	<u>21,146,952</u>

33 Assigned capital

	2019	2018
	Rs.'000	Rs.'000
Assigned Capital	3,152,358	3,152,358
	<u>3,152,358</u>	<u>3,152,358</u>

34 Statutory reserve fund

	2019	2018
	Rs.'000	Rs.'000
Opening balance	2,473,286	2,350,855
Transferred during the year	124,872	122,431
Closing balance	<u>2,598,158</u>	<u>2,473,286</u>

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.

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35	Other reserves	2019	2018
		Rs.'000	Rs.'000
	Exchange equalisation of reserve (Note 35.1)	9,362,367	9,550,267
	Other comprehensive income / (loss) reserve (Note 35.2)	807,371	(263,377)
	Revaluation reserve (Note 35.3)	2,462,087	2,558,033
	IFA reserve (Note 35.4)	2,970,075	4,725,708
	SBP reserve (Note 35.5)	168,501	168,453
		<u>15,770,401</u>	<u>16,739,084</u>
35.1	Exchange equalisation of reserve	2019	2018
		Rs.'000	Rs.'000
	Opening balance	9,550,267	5,629,182
	Fluctuation of foreign exchange reserves	(187,900)	3,921,085
	Closing balance	<u>9,362,367</u>	<u>9,550,267</u>
35.2	Fair value through other comprehensive income reserve	2019	2018
		Rs.'000	Rs.'000
	Opening balance	(263,377)	743,645
	Net gain / (loss) on revaluation	1,070,748	(1,007,022)
	Closing balance	<u>807,371</u>	<u>(263,377)</u>
35.3	Revaluation reserve	2019	2018
		Rs.'000	Rs.'000
	Opening balance	2,558,033	2,521,648
	Revaluation surplus / (deficit) for the year	(95,945)	36,385
	Closing balance	<u>2,462,088</u>	<u>2,558,033</u>
35.4	IFA reserve	2019	2018
		Rs.'000	Rs.'000
	Opening balance	4,725,708	5,108,459
	Transferred during the year	(1,755,633)	(382,751)
	Closing balance	<u>2,970,075</u>	<u>4,725,708</u>
35.5	Share based payment reserve	2019	2018
		Rs.'000	Rs.'000
	Opening balance	168,453	168,234
	Transferred during the year	48	219
	Closing balance	<u>168,501</u>	<u>168,453</u>

According to the guidelines issued by the Central Bank of Sri Lanka, Banks were 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. Movement for the financial year came as a result of maturities of several bonds in the portfolio.

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35.5 HSBC Restricted Shares based payments and share option plan

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). In addition, HSBC Sri Lanka had a share based payment scheme available for its employees, which provided share options to the employees. Even though this scheme has ceased, the related liability towards the group has been accounted in books as a part of equity.

35.5.1 Restricted share awards - No of shares	2019	2018
Outstanding at the beginning	22,547	23,002
Awards during the year	9,409	17,757
Vested during the year	(12,355)	(18,212)
Outstanding at the end	19,601	22,547

35.5.2 Share-based payments income statement charge	Rs.'000	Rs.'000
Restricted and performance share awards	14,114	20,373
	14,114	20,373

36 Events occurring after the reporting date

The ECL as at 31st December 2019 was estimated based on a range of forecast economic conditions as at that date. Since early January 2020, the coronavirus outbreak has spread across mainland China and beyond, causing disruption to business and economic activity. The impact on GDP and other key indicators will be considered when determining the severity and likelihood of downside economic scenarios that will be used to estimate ECL under IFRS 9 in 2020.

37 Comparative figures

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

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38 Commitments and contingencies

38.1 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.

	2019	2018
	Rs.'000	Rs.'000
Performance bonds	15,827,296	9,000,541
Letters of credit	10,797,359	6,420,366
Other contingent items	75,178,198	63,441,836
Undrawn loan commitments	171,421,356	183,240,708
Foreign exchange contracts *	202,221,938	325,991,347
Derivatives- principal amount	-	4,572,750
Other contra accounts	18,175,521	19,915,155
Total	<u>493,621,668</u>	<u>612,582,703</u>

38.2 Movements in Impairment during the Year

	2019	2018
	Rs.'000	Rs.'000
Opening balance	77,348	33,713
Charge/ (Write back) to income statement	(16,376)	33,788
Exchange rate variance and other adjustments	2,552	9,847
Closing balance	<u>63,524</u>	<u>77,348</u>

* Foreign exchange contracts include sales and purchases elements of booked transactions.

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38 Commitments and contingencies (contd)

38.3 Pending litigations against the Branch as at 31 December 2019

1. Court action has been taken under case no.HC/CIVIL/338/12 where case filed by the plaintiff against other three defendants for alleged malicious prosecution. The bank has been enlisted as the 4th defendant for giving evidence on certain transactions of the plaintiff.
2. Three Labour Tribunal actions have been taken under case numbers LT 01/32/2016, LT 01/AD/51/2016 and LT 24/478/2016 by former staff members for alleged unfair termination.
3. Case no. 254/2014/DSP filed in District Court of Colombo where the plaintiff Cargills PLC alleges that the recent installation of air condition cooling towers by the Branch in the space between two buildings has caused them inconveniences and nuisance.
4. Court action has been initiated by H Abeywickrema ; a customer in proceedings case no:DMR 1384/2016; suing the Bank for professional negligence and breach of duty of care as a result of the incorrect overseas travel details been updated and for subsequent collection related activities.
5. Case no. DMR 02342/16 filed in District Court of Colombo where the plaintiff Litro Gas Lanka Limited alleges that the bank has not effected the requested transfer and has hold payment without assigning a reason , due to this additional cost and loss of interest was incurred by the Plaintiff as they had to facilitate the payment through another Bank.
6. Law suit instituted by a former staff (Plaintiff) case no: 2369/2016/MR , demanding for compensation for causing him the pain of mind further to his termination from the services of the Bank.
7. Case No: DMR 00285/17, has been instituted by M S A Shipping (Pvt) Ltd (The Plaintiff) has filed the action against Mr Asela Tennakoon - the First Defendant, who has credited 12 cheques, drawn by OPPO Lanka (Pvt) Ltd in favour of “MSA Shipping (Pvt) Ltd 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.
8. High Court - Appeal Case No : HCALT 23/2018 Former staff member instituted legal action for alleged unfair termination at the Labour Tribunal (LT) .The Order of the LT was delivered on 28 February 2018 and the LT upheld the position of the Bank accordingly the Applicants case was dismissed. The Applicant has now appealed to the High court to squash the Order given by the LT President.
9. The Honourable Minister of Labour has referred two disputes (A/34/2017 and A/25/2017) pertaining to the payment of Pension for two former staff, which is currently pending with the Commissioner of Labour , for compulsory Arbitration.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH - DOMESTIC BANKING UNIT
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

AS AT 31 DECEMBER

38 Commitments and contingencies (contd)

38.3 Pending litigations against the Branch as at 31 December 2019 (contd)

10. District Court of Colombo - Case No: DSP/228/18 -The Director-Department of Supervision of Non-Bank Financial Institutions- Central Bank of Sri Lanka (Petitioner) has instituted action against ETI Finance Limited, its four Directors and 10 other Financial Institutions, as the Respondents. HSBC Sri Lanka has been named as the 7th Respondent. It is noteworthy that there is no claim or allegation levelled in this case against HSBC, even though the case has named HSBC the 7th Respondent. HSBC can make use of the hearings of the case (by being a party to the case) to make its objections and present its claims against the Directors based on the dues of each Director to the Bank.
11. Civil High Court of the Western Province/ Commercial High Court of Colombo case no- 734/18/MR - Prince Shirley Rodrigo Sathianathen (Plaintiff) as instituted litigation against HSBC claiming that HSBC Sri Lanka has wrongfully disbursed the estate of the late Mr. Philip Rodrigo Sathianathen (the deceased customer) to the survivor of the joint accounts held with the deceased customer.
12. The Plaintiff - Southern Sun Teas (Pvt) Ltd, previously filed action in the Commercial High Court of Colombo against HSBC, under the case no, HC/Civil. 422/2016, for HSBC not honouring the Guarantee No 070096, date 23 Jan 2007, which HSBC had issued in favour of the Plaintiff ,pursuant to an Admiralty matter.

HSBC contended that the demand by the Plaintiff for the said guarantee was not a complying demand as per the conditions of the said guarantee and also took the position that, lacks of jurisdiction to hear the case.

Considering the arguments of HSBC , the Commercial High Court dismissed the action upholding the position that it does not have jurisdiction over the matter.

Pursuant to that, Plaintiff entered into a settlement with the defendants it Action in Rem (12/2006) , in which case Southern Sun Teas received a sum of USD 100,000/- from the defendant as a term of settlement.

Now , Plaintiff has filed this new action (HC (Civil) CHC 366/2019/MR) against HSBC in the Commercial High Court (in the same Court as above) claiming that even though they settled the Action in Rem with the defendant for a sum of USD 100,000/- , they are still at a loss of USD 1,550,000/- as a result of HSBC not honouring their initial demand for the said guarantee.

There are no material contingent liabilities outstanding as at the reporting date other than those disclosed above. The management believes matters relating to these litigations will resolve in favour of the Bank and therefore no provisions have been made against these contingent liabilities.

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

FOR THE YEAR ENDED 31 DECEMBER

39 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.

39.1 Transactions with related parties

(a) Interest paid to other HSBC Branches and Group companies	2019	2018
	Rs.'000	Rs.'000
Other HSBC Branches		
HSBC Hongkong	4,096,768	3,300,950
HSBC New Zealand	-	43
HSBC Singapore	-	1
	4,096,768	3,300,994
Group companies		
HSBC London	54	212
HSBC Canada	-	1
HSBC Data Processing Ltd	27,343	126,895
HSBC Middle East	-	7
HSBC France	141	-
	27,538	127,115
(b) Interest received from other HSBC Branches and Group companies	2019	2018
	Rs.'000	Rs.'000
Other HSBC Branches		
HSBC Hongkong	896,258	667,025
	896,258	667,025
Group companies		
HSBC USA	-	6
HSBC Data Processing Ltd	-	35
	-	41
(c) Commission paid to other HSBC Branches and Group companies	2019	2018
	Rs.'000	Rs.'000
Other HSBC Branches		
HSBC Hongkong	30,168	33,645
HSBC New Zealand	168	233
HSBC Japan	87	89
HSBC Singapore	383	236
HSBC Thailand	404	324
	31,210	34,527
Group companies		
HSBC London	583	1,429
HSBC Canada	554	-
HSBC China	27	2
HSBC Australia	1,455	1,421
HSBC USA	46,394	43,777
HSBC France	2,168	-
	51,181	46,629

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE YEAR ENDED 31 DECEMBER

39 Related Party Disclosures (contd)

39.1 Transactions with related parties (contd)

(d) Commission Received from Other HSBC Branches and Group Companies	2019	2018
	Rs.'000	Rs.'000
Other HSBC branches		
HSBC Hongkong	93,361	68,166
HSBC Japan	5,402	4,277
HSBC Singapore	4,448	3,091
HSBC India	4,542	2,278
HSBC Vietnam	615	420
HSBC Malaysia	1,813	1,643
	110,181	79,875
Group companies		
HSBC London	11,179	11,357
HSBC Canada	24	75
HSBC France	177	132
HSBC China	21,049	7,695
HSBC Australia	252	170
HSBC Zurich	1,383	1,246
HSBC USA	2,535	1,870
HSBC Turkey	-	56
HSBC Data processing Ltd	544	820
HSBC Trinkaus and Burkhardt	113	76
HSBC United Arab Emirates	883	1,052
HSBC Germany	53	-
HSBC Netherlands	23	-
	38,215	24,549
(e) Other Operating Income - Other HSBC Branches and Group Companies		
Other HSBC branches		
HSBC Maldives	36,134	32,997
	36,134	32,997

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE YEAR ENDED 31 DECEMBER

39 Related Party Disclosures (contd)

39.1 Transactions with related parties (contd)

(f) Receivable from other HSBC Branches and Group companies

	2019	2018
	Rs.'000	Rs.'000
Other HSBC Branches		
HSBC Hongkong	50,892,757	50,386,583
HSBC New Zealand	30,505	92,981
HSBC Japan	136,236	79,729
HSBC Singapore	66,130	318,245
HSBC India	2,483,935	4,601,652
HSBC Thailand	152	-
HSBC Maldives	34,264	40,785
	<u>53,643,979</u>	<u>55,519,975</u>
Group companies		
HSBC London	590,846	3,281,679
HSBC China	1,030,638	31,279
HSBC Canada	19,045	9,489
HSBC USA	4,284,217	12,012,065
HSBC Data processing Ltd	-	319,100
HSBC France	180,590	-
HSBC United Arab Emirates	9,385	241
HSBC Credit Comml De France SA	-	181,915
HSBC Australia	53,990	26,894
	<u>6,168,711</u>	<u>15,862,662</u>

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

FOR THE YEAR ENDED 31 DECEMBER

39 Related party disclosure (contd)

39.1 Transactions with related parties (contd)

(g) Payable to other HSBC Branches and Group companies	2019	2018
	Rs.'000	Rs.'000
Other HSBC Branches		
HSBC Hongkong	158,477,636	160,041,761
HSBC Japan	41,076	7,582
HSBC Singapore	31,500	3,074
HSBC India	828,396	2,348,871
HSBC Bangladesh	337,916	454,647
HSBC Maldives	1,069	1,205
HSBC Vietnam	12	-
HSBC Mauritius	27,528	-
HSBC Malaysia	2,137	-
	159,747,270	162,857,140
Group companies		
HSBC London	831,999	2,613,165
HSBC Baharain	820	629
HSBC Canada	12	36
HSBC China (Bank) Co. Ltd	25,974	10,718
HSBC USA	590,141	319,551
HSBC Securities (New York)	-	2,247
HSBC Data Processing Ltd - Sri Lanka	2,730,033	1,931,546
HSBC Bank Malaysia Berhad	-	2,559
HSBC Bank (Singapore) Limited	-	27,016
HSBC Kuwait	-	436
HSBC France	20,920	2,107,012
HSBC Qatar	1,798	2,050
HSBC Vietnam	-	185
HSBC Trinkaus & Burkhardt	33	66
HSBC UAE	8,562	2,243
HSBC Global Services Limited	9,856	864
HSBC Australia	2,294	805
	4,222,442	7,021,128

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

FOR THE YEAR ENDED 31 DECEMBER

39 Related party disclosure (contd)

39.2 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.

(a) Compensation of KMPs

	2019	2018
	Rs.'000	Rs.'000
Aggregate remuneration paid for the year	310,849	291,548
	310,849	291,548

(b) Transactions with KMPs and their close relations

	2019	2018
	Rs.'000	Rs.'000
Total deposits	59,931	46,982
Total accommodation granted	265,552	241,804
	325,483	288,786

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management

40.1 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 Credit & Market Risk, Retail Banking & Wealth Management (RBWM) Risk, Information Security Risk, Operational 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 Risk Management Meeting ('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, 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.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.1 Risk management framework (contd)

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 economy slow-down into three scenarios (severe crisis, moderate and mild scenarios) which are developed by applying shocks of varying severity.

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 "Design Authority (DA)" for approval. DA consists of CFO, CRO & Regional Head of Stress Testing. 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.

40.2 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.

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.2 Credit risk (contd)

40.2.1 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) or Head of RBWM Risk for Retail Banking and CEO for Corporate banking 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.

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 III 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 computes Expected Credit Losses (ECLs) appropriately.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.2 Credit risk (contd)

40.2.1 Credit risk management (contd)

Credit impaired loans

HSBC determines that a financial instrument is credit impaired and in stage 3 by considering relevant objective evidence, primarily whether:

- contractual payments of either principal or interest are past due for more than 90 days;
- there are other indications that the borrower is unlikely to pay, such as when a concession has been granted to the borrower for economic or legal reasons relating to the borrower's financial condition; and
- the loan is otherwise considered to be in default. If such unlikeliness to pay is not identified at an earlier stage, it is deemed to occur when an exposure is 90 days past due. Therefore, the definitions of credit impaired and default are aligned as far as possible so that stage 3 represents all loans that are considered defaulted or otherwise credit impaired.

Impairment and credit risk mitigation

The existence of collateral has an impact when calculating ECLs on stage 3 assets. (credit impaired assets) 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 ECLs individually, where recovery is projected for each loan using a discounted cash flow method. If exposures are secured, the current net realizable value of the collateral will be taken into account when assessing the need for individually assessed ECLs.

Personal lending portfolios are generally assessed for impairment on a collective basis as the portfolios typically consist of large groups of homogeneous loans.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.2 Credit risk (contd)

40.2.1 Credit risk management (contd)

Impairment and credit risk mitigation (contd)

The impairment requirements under IFRS 9 are based on an Expected Credit Losses ('ECL') concept that requires the recognition of ECL in a timely and forward-looking manner.

The assessment of credit risk, and the estimation of ECL, are unbiased and probability-weighted, and incorporate all available information which is relevant to the assessment including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money.

In general, HSBC calculates ECL using three main components: a probability of default, a loss given default ('LGD') and the exposure at default ('EAD').

The 12-month ECL is calculated by multiplying the 12-month PD, LGD and EAD. Lifetime ECL is calculated using the lifetime PD instead.

The 12-month and lifetime PDs represent the probability of default occurring over the next 12 months and the remaining maturity of the instrument respectively.

ECLs are calculated for all Retail products and will be done on product level. The determination of ECL is based on the concept of 'staging' which reflects the general classification of credit deterioration of an asset which is primarily on delinquency days. Assets must be allocated into appropriate credit deterioration stages (Stage 1, Stage 2 and Stage 3) before ECL calculations can be performed. The stages drive the recognition of ECLs.

ECL is determined via a two-step approach, where the financial instruments are first assessed for their relative credit deterioration, followed by the measurement of the ECL (which depends on the credit deterioration categories).

Financial instruments that are performing are considered to be 'Stage 1'. Financial instruments which are considered to have experienced a significant increase in credit risk are in 'Stage 2'. Financial instruments for which there is objective evidence of impairment so are considered to be in default or otherwise credit impaired are in 'Stage 3'.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.2 Credit risk (contd)

40.2.1 Credit risk management (contd)

Impairment and credit risk mitigation (contd)

An assessment of whether credit risk has increased significantly since initial recognition is performed at each reporting period by considering the change in the risk of default occurring over the remaining life of the financial instrument. The assessment explicitly or implicitly compares the risk of default occurring at the reporting date compared with that at initial recognition, taking into account reasonable and supportable information, including information about past events, current conditions and future economic conditions. The assessment is unbiased, probability-weighted, and to the extent relevant, uses forward-looking information consistent with that used in the measurement of ECL. The analysis of credit risk is multifactor. The determination of whether a specific factor is relevant and its weight compared with other factors depends on the type of product, the characteristics of the financial instrument and the borrower. Therefore, it is not possible to provide a single set of criteria that will determine what is considered to be a significant increase in credit risk, and these criteria will differ for different types of lending, particularly between retail and wholesale. However, unless identified at an earlier stage, all financial assets are deemed to have suffered a significant increase in credit risk when 30 days past due. In addition, wholesale loans that are individually assessed, typically corporate and commercial customers, and included on a watch or worry list, are included in stage 2.

In the absence of a significant increase in credit risk, 12-month ECL should be recognized from initial recognition (except POCI). Financial instruments that are credit-impaired upon initial recognition are POCI (Purchase or originated credit impaired). Therefore, performing financial instruments in Stage 1 will recognize 12-month ECL. The underlying principle of the ECL model is that lifetime ECL is recognized when there has been a significant increase in credit risk since initial recognition..

The transfers between the stages are symmetrical, ie a financial instrument could deteriorate from Stage 1 to 2 or 3, but it can also recover from stage 3 to 2 or 1. The only exception being POCI financial assets, where it will always remain in this category until de recognition.

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.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.2 Credit risk (contd)

40.2.1 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.

Contractual amount outstanding of financial assets written off during the reporting period that are still subject to enforcement activity are as follows;

As at 31 December	2019	2018
LKR '000		
Retail	887,899	548,674
Corporate	451,165	-
	1,339,065	548,674

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. Valuation of tangible collateral is periodically done according to bank's collateral policy.

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.

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.2 Credit risk (contd)

40.2.1 Credit risk management (contd)

Maximum exposure to credit risk before collateral held or other credit enhancements

As at 31 Decemeber	2019	2018
LKR 000's		
Balances with Central Bank	1,800,000	-
Placements with banks	27,214,500	49,385,700
Financial assets measured at fair value through profit or loss	4,751,028	11,516,593
Financial assets at amortised cost - loans and advances	260,155,127	255,830,603
Financial assets measured at fair value through other comprehensive income	107,854,554	100,949,137
Acceptance & endorsements	6,349,354	6,843,206
	408,124,563	424,525,239

Impairment movement of financial assets/liabilities

Consolidated	Stage 1	Stage 2	Stage 3	Total
LKR '000				
Opening Balance	1,085,103	617,961	731,775	2,434,839
Write back to income statement	(73,746)	(64,356)	(182,975)	(321,078)
Exchange/other	(2,947)	(11,720)	(10,567)	(25,234)
	1,008,409	541,885	538,233	2,088,527

Wholesale loans and advances portfolio is subject to individual assessment when an exposure is classified as default or the branch no longer expect to recover the principal and interest due on a loan in full in accordance with original terms and conditions of the facility. Retail banking portfolios due to the homogeneous nature of the products, are assessed collectively.

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.2 Credit risk (contd)

40.2.2 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	Average gross exposure	Gross exposure	Average gross exposure
	2019	2019	2018	2018
	Rs.000	Rs.000	Rs.000	Rs.000
By product - local currency				
Overdrafts	19,060,896	21,930,367	21,199,830	19,750,792
Term loans	49,294,096	46,433,066	41,094,094	38,762,837
Credit cards	26,037,785	25,258,121	24,428,098	22,594,078
Other loans	27,191	2,119,915	131,298	65,055
Sub total	<u>94,419,968</u>	<u>95,741,468</u>	<u>86,853,320</u>	<u>81,172,762</u>
By product - foreign currency				
Overdrafts	17,849,994	16,997,544	14,659,470	9,680,743
Term loans	134,714,795	141,033,619	155,341,713	142,045,719
Other loans	14,877,407	10,345,557	1,128,286	919,453
Sub total	<u>167,442,196</u>	<u>168,376,721</u>	<u>171,129,469</u>	<u>152,645,915</u>
Total	<u><u>261,862,164</u></u>	<u><u>264,118,189</u></u>	<u><u>257,982,789</u></u>	<u><u>233,818,677</u></u>

Gross Loans and Receivables - By Currency

Loans and Receivables to Other Customers		
	2019	2018
	Rs.000	Rs.000
By Product - Currency		
Sri Lankan Rupee	94,419,969	86,853,321
United States Dollar	162,686,358	166,876,051
Great Britain Pound	287,652	-
Others	4,468,185	4,253,417
Total	<u><u>261,862,164</u></u>	<u><u>257,982,789</u></u>

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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40 Financial risk management (contd)

40.2 Credit risk (contd)

40.2.2 Quantitative Disclosures

Gross Loans and Receivables

Loans and Receivables to Other Customers: Individual impairment - Sector wise

	2019	2018
	Rs.000	Rs.000
By Product - Local Currency		
Manufacturing	-	300,795
Other services	<u>45,453</u>	<u>46,683</u>
Total	<u><u>45,453</u></u>	<u><u>347,478</u></u>

Loans and Receivables to Other Customers: Collective impairment - Counterparty wise

	2019	2018
	Rs.000	Rs.000
Retail	1,126,954	872,024
Wholesale	<u>534,629</u>	<u>932,684</u>
	<u>1,661,584</u>	<u>1,804,708</u>

Stage 1, 2 and 3 excluding wholesale individually assessed stage 3 expected credit losses are considered as collective provisions for this note.

Loans and Receivables to Other Customers: Individual impairment charge/(reversal) during the year - Counterparty wise

	2019	2018
	Rs.000	Rs.000
Corporate	<u>(387,007)</u>	<u>(21,118)</u>
	<u>(387,007)</u>	<u>(21,118)</u>

Above disclosure carries impairment charge/(reversals) of individually assessed wholesale exposures. Retail portfolios due to its homogeneous nature are treated collectively.

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31 DECEMBER

40 Financial Risk Management (Continued)

40.2 Credit risk (contd)

40.2.2 Quantitative Disclosures (Continued)

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	2019 Total Rs. 000	2018 Total Rs. 000
Agriculture & Fishing	-	451,441	1,806,394	-	-	2,008,930	-	4,266,765	4,515,815
Manufacturing	3,344,662	24,232,664	17,069,919	-	13,015,193	35,246,610	-	92,909,048	80,759,461
Tourism	53,885	-	2,349,390	-	-	43,398,326	-	45,801,601	37,999,229
Transport	5,701	-	1,417,445	-	5,631,093	6,434,214	-	13,488,453	15,830,302
Construction	-	-	1,841,752	-	-	5,769,214	-	7,610,966	5,724,129
Traders	12,462,679	664,753	4,470,941	-	4,808,624	1,035,558	-	23,442,555	30,151,021
New Economy	47,589	-	92,042	-	768,383	8,962,971	-	9,870,985	10,728,457
Financial and Business Services	-	-	994,087	-	3,046,550	1,312,037	-	5,352,674	7,526,148
Infrastructure	-	-	2,917	-	-	-	-	2,917	-
Other Services	-	-	2,313,929	-	300,255	5,422,631	-	8,036,815	14,032,989
Credit card	-	-	-	26,037,785	-	-	-	26,037,785	24,428,098
Other	-	-	4,552,044	-	-	18,737,672	1,751,884	25,041,600	26,287,140
Total	15,914,515	25,348,858	36,910,860	26,037,786	27,570,098	128,328,162	1,751,884	261,862,164	257,982,789

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31 DECEMBER

40 Financial Risk Management (Continued)

40.2 Credit risk (contd)

40.2.2 Quantitative Disclosures (Continued)

Total Gross Loans and receivables including acceptances - 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	2019 Total Rs. 000	2018 Total Rs. 000
Overdrafts	36,910,890	-	-	-	-	-	-	-	36,910,890	35,859,299
Term lending	6,011,012	14,841,413	31,628,400	6,529,746	12,241,767	38,413,173	56,008,256	11,754,964	177,428,731	191,252,965
Non-eligible bills	4,244,418	5,047,850	5,597,814	14,514	-	-	-	-	14,904,596	1,259,583
Money market placements	1,818,600	2,540,000	280,000	-	-	-	-	-	4,638,600	3,014,100
Credit card advances	26,037,785	-	-	-	-	-	-	-	26,037,785	24,428,098
Mortgages	230,211	19	755	854	3,239	59,402	97,838	1,549,244	1,941,562	2,168,744
Total gross loans and receivables	75,252,916	22,429,282	37,506,969	6,545,114	12,245,006	38,472,575	56,106,094	13,304,208	261,862,164	257,982,789
Acceptances	677,305	1,825,938	2,708,175	993,769	144,167	-	-	-	6,349,354	6,843,206
Total	75,930,221	24,255,220	40,215,144	7,538,883	12,389,173	38,472,575	56,106,094	13,304,208	268,211,518	264,825,995

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.2 Credit risk (contd)

40.2.2 Quantitative disclosures (contd)

Gross loans and receivables - Sector wise analysis of past due nor impaired and impaired loans

Sector	Past due nor impaired		Impaired	
	2019 Total Rs. 000	2018 Total Rs. 000	2019 Total Rs. 000	2018 Total Rs. 000
Agriculture and fishing				
Manufacturing	2,715,073	3,089,770	-	354,735
Tourism	34,281	256,074	134,374	174,931
Transport	369,646		-	
Construction	-		-	
Traders	4,276,931	365,748	-	
New economy	39,980	93,012	2,230	2,458
Financial and business services	-		-	
Infrastructure	-		-	
Other services	348,923	209,552	80,552	83,675
Credit card	-		-	
Other	1,074,420	1,267,387	1,425,642	1,262,725
Total	8,859,253	5,281,545	1,642,799	1,878,524

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial Risk Management (Continued)

40.2 Credit risk (contd)

40.2.2 Quantitative Disclosures (Continued)

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	2019 Total Rs. 000	2018 Total Rs. 000
Cash and cash equivalents	18,162,365	15,823,921	-	-	-	-	-	33,986,286	23,502,316
Balances with central banks	9,740,145	-	-	-	-	-	-	9,740,145	7,332,880
Placements with banks	-	27,214,500	-	-	-	-	-	27,214,500	49,385,700
Derivative financial instruments	26,825	712,417	72,879	-	-	-	-	812,121	4,466,754
Financial assets measured at fair value through profit or loss	4,751,028	-	-	-	-	-	-	4,751,028	11,516,593
Loans and receivables to customers	826,888	9,730,356	237,737,374	3,065,494	8,859,253	1,642,799	(1,707,037)	260,155,127	255,830,603
Financial assets measured at fair value through other comprehensive income	107,854,554	-	-	-	-	-	-	107,854,554	100,949,137
Financial assets at amortised cost - debt instruments	3,099,917	-	-	-	-	-	(11,603)	3,088,314	5,308,259
Acceptances	-	9,798	5,343,705	-	995,851	-	-	6,349,354	6,843,206
Total	144,461,722	53,490,992	243,153,958	3,065,494	9,855,104	1,642,799	(1,718,640)	453,951,429	465,135,448

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial Risk Management (Continued)

40.2 Credit risk (contd)

40.2.2 Quantitative Disclosures (Continued)

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

Sector	Contractual residual maturity								Total Rs. 000
	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	
2019	6,073,912	847,893	2,714	8,424	36,302	1,240,578	455,108	194,322	8,859,253
2018	3,596,806	224	1,192	3,569	82,943	693,007	541,451	362,353	5,281,545

The impairment charges for loans and receivables is disclosed in Note 11. The movement in provision for impairment is disclosed in Note 21.2.

Collateral held and other credit enhancements and their financial effect

	2019		2018	
	Carrying amount of the exposure LKR'000	Carrying amount of the collateral LKR'000	Carrying amount of the exposure LKR'000	Carrying amount of the collateral LKR'000
Loans and receivables to customers	260,155,127	96,298,408	255,830,603	99,733,162

The note aims to provide carrying value of collaterals held by the Bank of its customers where, they can be liquidated at market value with reasonable certainty. Collaterals such as cash, guarantees from corporates, banks, property and fixed assets pledged are considered as eligible for consideration. Collateral relating to past due but not impaired and impaired loans as at 31 December 2019 amounts to LKR 3,323,716,601/-

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.3 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.

40.3.1 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.

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40 Liquidity risk (contd)

40.3. 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 based on undiscounted cash flows

Undiscounted cash-flows include capital and interest payable on interest bearing liabilities, spread across its 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	2019 Total Rs. 000	2018 Total Rs. 000
Due to banks	13,123,500	13,305,244	21,419,295	10,085,089	47,207,511	37,632,274	28,134,829	7,332,565	178,240,307	188,609,977
Derivative financial instruments	1,052,576	-	-	-	-	-	-	-	1,052,576	3,875,848
Financial liabilities at amortised cost - due to depositors	129,309,681	13,569,210	21,396,606	18,217,861	18,238,521	13,892,182	1,931,609	-	216,555,670	211,034,168
Acceptances	677,330	1,825,959	2,708,236	993,848	143,982	-	-	-	6,349,354	6,843,206
Total	144,163,087	28,700,413	45,524,137	29,296,798	65,590,014	51,524,456	30,066,438	7,332,565	402,197,907	410,363,199

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.4 Market risk

The risk that movements in market factors, including foreign exchange rates, 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.

40.4.1 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.

40.4.2 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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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.4 Market risk (contd)

40.4.2 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.

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.4 Market risk (contd)

40.4.2 Risk management (contd)

Foreign exchange position

Currency (LKR' million)	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				
US Dollars	207,301	(226,610)	(19,308)	186,128	(166,472)	19,656	371	-	2	371
Pound Sterling	22,752	(28,675)	(5,923)	6,697	(774)	5,922	(1)	-	-	(1)
Euro	5,273	(6,767)	(1,494)	15,162	(13,670)	1,492	(10)	-	-	(10)
Japanese Yen	7,917	(7,919)	(1)	6	(1)	5	(4)	-	-	(4)
Australian Dollar	14,820	(19,205)	(4,385)	6,700	(2,306)	4,394	8	-	-	8
Canadian Dollar	7,186	(7,551)	(366)	738	(362)	376	9	-	-	9
Other currencies	168,662	(137,193)	31,468	137,169	(169,015)	(31,845)	10	-	-	10
Total exposure	433,911	(433,920)	(9)	352,600	(352,600)	-	383	-	2	383
Total capital funds as per the latest audited financial statements										59,489
Total exposure as a % of total capital funds (Basel III) as per the latest audited financial statements (Should not exceed 30%)										0.6%

* Monitored at bank level

*Balances are in LKR Mn (Col 10 in FCY Mn)

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.4 Market risk (contd)

40.4.2 Risk management (contd)

Interest Rate risk in the Banking Book (IRRBB)

HSBC Sri Lanka has a robust mechanism to monitor and control the IRRBB , the structural interest rate risk is transferred to the Balance Sheet Management division who are the subject matter experts in managing same. This is done through the Interest Rate Risk Behavioralization Policy and the Interest Rate risk Transfer pricing policy. These policies are reviewed and approved by the Asset Liability Committee (ALCO) of the Bank on an annual basis. A monthly monitoring tool is available to monitor the net interest margins of customer lending and deposit products across the different business lines, and forms part of the monthly ALCO packs. Furthermore basis risk of the lending portfolio is monitored and reported to the ALCO on a quarterly basis , same is monitored against a ALCO set limit. Overall ALCO oversight on these aspects ensure that there is sufficient senior management oversight in evaluating the IRRBB of the bank.

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.4 Market risk (contd)

40.4.2 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	Non financial assets & liabilities	Total
Cash and cash equivalent	33,986,285	-	-	-	-	-	-	-	33,986,285
Balances with Central Bank	9,740,145	-	-	-	-	-	-	-	9,740,145
Placements with banks	27,214,500	-	-	-	-	-	-	-	27,214,500
Derivative financial instruments	812,121	-	-	-	-	-	-	-	812,121
Financial assets measured at fair value through profit or loss	171,296	1,090,191	144,987	3,696	260,486	3,080,372	-	-	4,751,028
Financial assets at amortised cost - loans and advances	99,563,262	41,226,049	10,319,019	13,263,669	39,594,092	47,962,264	8,226,772	-	260,155,127
Financial assets measured at fair value through other comprehensive income	20,756,712	4,096,683	16,713,098	29,915,876	20,640,192	15,731,993	-	-	107,854,554
Financial assets at amortised cost - debt instruments	43,481	-	-	8,449	3,036,384	-	-	-	3,088,314
Property, plant and equipment	-	-	-	-	-	-	-	5,212,836	5,212,836
Other assets	2,031,668	1,825,958	2,708,237	993,848	144,163	-	-	6,813,597	14,517,471
Total assets	194,319,470	48,238,881	29,885,341	44,185,538	63,675,317	66,774,629	8,226,772	12,026,433	467,332,381
Due to banks	26,400,887	20,902,369	9,978,650	44,155,241	35,773,460	26,286,486	7,102,804	-	170,599,897
Derivative financial instruments	1,052,576	-	-	-	-	-	-	-	1,052,576
Financial liabilities at amortised cost - due to depositors	139,513,369	20,504,445	17,362,922	17,362,535	13,223,252	1,838,599	-	-	209,805,122
Retirement benefit obligations	-	-	79,213	-	-	-	-	-	79,213
Deferred tax liability	-	-	366,423	-	-	-	-	-	366,423
Current tax liability	-	119,229	119,230	119,315	-	-	-	-	357,774
Other liabilities	1,552,958	1,443,832	1,530,754	761,419	117,241	-	-	13,038,902	18,445,106
Equity	-	-	-	-	-	-	-	66,626,270	66,626,270
Total liabilities	168,519,790	42,969,875	29,437,192	62,398,510	49,113,953	28,125,085	7,102,804	79,665,172	467,332,381
Cumulative gap	25,799,680	5,269,006	448,149	(18,212,972)	14,561,364	38,649,544	1,123,968	(67,638,739)	-

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	345,695	801,121	72,193	3,336,141	6,762,178	4,509,967	-	15,827,295
Letters of credit	3,509,423	5,246,097	1,548,799	493,040	-	-	-	10,797,359
Other contingent items	4,875,654	6,748,262	7,937,559	16,847,676	31,161,162	7,607,885	-	75,178,198
Undrawn loan commitments	171,421,357	-	-	-	-	-	-	171,421,357
Foreign exchange contracts	80,584,223	63,527,826	41,533,248	14,758,638	1,818,003	-	-	202,221,938
Other contra accounts	18,175,522	-	-	-	-	-	-	18,175,522
Total	278,911,873	76,323,306	51,091,798	35,435,496	39,741,343	12,117,852	-	493,621,668

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.4 Market risk (contd)

40.4.2 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	22,678,750	-	-	-	-	-	-	11,307,535	33,986,285
Balances with Central Bank	1,800,000	-	-	-	-	-	-	7,940,145	9,740,145
Placements with banks	27,214,500	-	-	-	-	-	-	-	27,214,500
Derivative financial instruments	812,121	-	-	-	-	-	-	-	812,121
Financial assets measured at fair value through profit or loss	171,296	1,090,191	144,987	3,696	260,486	3,080,372	-	-	4,751,028
Financial assets at amortised cost - loans and advances	142,384,202	77,719,772	11,151,965	6,069,446	5,075,309	11,814,132	4,535,137	1,405,164	260,155,127
Financial assets measured at fair value through other comprehensive income	20,756,712	4,096,682	16,713,098	29,915,876	20,640,193	15,731,993	-	-	107,854,554
Financial assets at amortised cost - debt instruments	43,481	-	-	8,449	3,036,384	-	-	-	3,088,314
Property, plant and equipment	-	-	-	-	-	-	-	5,212,836	5,212,836
Other assets	677,330	1,825,959	2,708,236	993,848	144,163	-	-	8,167,935	14,517,471
Total assets	216,538,392	84,732,604	30,718,286	36,991,315	29,156,535	30,626,497	4,535,137	34,033,615	467,332,381
Due to banks	49,962,275	65,780,232	14,514,400	13,983,069	4,172,890	2,721,450	3,586,410	15,879,171	170,599,897
Derivative financial instruments	1,052,576	-	-	-	-	-	-	-	1,052,576
Financial liabilities at amortised cost - due to depositors	87,012,689	20,504,445	17,362,922	17,362,535	13,223,252	1,838,599	-	52,500,680	209,805,122
Retirement benefit obligations	-	-	-	-	-	-	-	79,213	79,213
Deferred tax liability	-	-	-	-	-	-	-	366,423	366,423
Current tax liability	-	-	-	-	-	-	-	357,774	357,774
Other liabilities	677,330	1,825,959	2,708,236	993,847	144,163	-	-	12,095,571	18,445,106
Equity	-	-	-	-	-	-	-	66,626,270	66,626,270
Total liabilities	138,704,870	88,110,636	34,585,558	32,339,451	17,540,305	4,560,049	3,586,410	147,905,102	467,332,381
Cumulative gap	77,833,522	(3,378,032)	(3,867,272)	4,651,864	11,616,230	26,066,448	948,727	(113,871,487)	-

The interest sensitive assets and liabilities are derived based on the nature of the product/item and classified under different time bands based on the residual maturity.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.5 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 (RMM) 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:

Risk and Control Assessment process is in place that facilitates the assessment of risk and the associated control environment for all operational risks faced by the bank

Classification of all information based on the potential risk to the Branch, its customers and related parties. This classification is used to invoke policies and procedures to protect the confidentiality and integrity of information.

Vendor management process is in place where due diligence performed by business departments forms part of the risk assessment process. Selecting a financially viable and Non sanctioned vendor with appropriate capability, skills and experience is essential part of the HSBC vendor due diligence process in managing risk .

The Branch 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 describe 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) and Affiliates or externally, to suppliers, where this enables the work to be performed more efficiently gaining economies of scale within the business, due to lack of specialist knowledge or resource constraints. Guidance on the outsourcing of work is contained in the Group policies & procedures and the outsource direction issued by Central Bank of Sri Lanka and Hong Kong Monetary Authority .

Group Insurable Risk (IR) is mandated by the Group Management Board (GMB) to arrange global insurance policies covering: Crime, Civil & Cyber Liability (CCC), Directors' & Officers' Liability including Outside Directors' & Officers' (D&O/ODL), Pension Trustees Liability (PTL). Collectively the three policies are the "Financial Lines Insurance Programmes/Policies". Cover is provided for HSBC Holdings plc and all wholly and majority owned subsidiaries. Policies are placed with insurers in the UK, US, Bermuda and other international markets by the Group's global insurance broker (Aon).

The Branch is investing in digital technology to improve the service it provides to customers and stay competitive. The mobile apps are one of the ways the Branch helps customers to manage their money more quickly, conveniently and safely.

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.5 Operational risk (contd)

Cybersecurity continues to be a focus area and is routinely reported at the Board level to ensure appropriate visibility, governance and executive support for the ongoing cybersecurity activities. The branch continues to strengthen and invest significantly in both business and technical controls in order to prevent, detect and respond to an increasingly hostile cyber threat environment. These include enhancing controls to protect against advanced malware, data leakage, infiltration of payments systems and denial of service attacks.

The Branch has given priority for the Baseline Security Standards introduced by Central Bank of Sri Lanka and compliant with relevant requirements to assure the level of security to customers and regulator .

The Branch continues to monitor and improve service resilience across its technology infrastructure, enhancing problem diagnosis/resolution and change execution capabilities to reduce service disruption to the customers .

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 2019 for the Branch (HSBC Sri Lanka) was LKR 4,208,165/-.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.6 Capital management

Qualitative disclosures

Capital adequacy ratio (CAR) is calculated based on the Central Bank of Sri Lanka (CBSL) directions stemming from Basel III accord. These guidelines require the Bank to maintain a CAR not less than 8.5% with minimum Tier 1 capital with buffers in relation to total risk weighted assets and a minimum total CAR with buffers of 12.5% in relation to total risk weighted assets.

Tier 1 Capital – Core Capital

This includes assigned capital, statutory reserve fund, published retained profits, accumulated other comprehensive income, general and other reserves. The assigned capital is the amount provided by HSBC Asia Pacific to conduct its operation in Sri Lanka. In order to avoid stress on capital and in line with the guidance given by the Basel Committee on Banking Supervision, licensed banks can stagger audited additional credit loss provisions arising from SLFRS 09 when compared with credit loss provisions under LKAS 39 as at first day of adoption of SLFRS 9, net of any other adjustment on first day impact to retained earnings and net of tax effects, throughout a transitional period of four years for the purpose of calculating CAR under Banking Act Directions No. 01 of 2016 on Capital Requirements under Basel III.

Tier 2 Capital – Supplementary capital

Revaluation gains and general provision are the only constituents 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%. According to explanatory note no. 03 of 2019 on interpretations of Banking Act Directions no.01 on capital requirements under Basel III for licensed commercial banks and licensed specialized banks; general provisions consist of impaired assets from stage 1 and 2 on the proportion of 100% and 50% respectively. This is subject to 1.25% of risk weighted assets on credit risk under the standardized approach shall be applicable for Tier 2 capital.

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.6 Capital management (Contd.)

40.6.1 Quantative disclosures

Composition of regulatory capital (audited)	2019	2018
	Rs'000	Rs'000
Equity capital or stated capital/assigned capital	3,152,358	3,152,358
Reserve fund	2,598,157	2,473,285
Published retained earnings/(Accumulated retained losses)	43,141,527	36,882,472
Accumulated other comprehensive income (OCI)	5,203,062	4,476,850
General and other disclosed reserves	3,138,575	4,894,161
Total Common Equity Tier I (CET1) Capital	57,233,678	51,879,126
Deductions to tier 1 capital	(35,654)	(24,443)
Net deferred tax assets	-	-
Amounts due to head office and branches outside Sri Lanka in Sri Lanka Rupees (-)	(35,654)	(24,443)
Total Tier 1 Capital	57,269,332	51,903,569
Components of tier 2 capital		
Revaluation reserves (as approved by CBSL)	1,049,765	1,049,765
General provisions*	1,169,605	-
Total qualifying tier 2 capital prior to deductions	2,219,370	1,049,765
Total Capital	59,488,702	52,953,334

* Please refer qualitative disclosure on tier 2 capital for explanation

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

FOR THE YEAR ENDED 31 DECEMBER

40 Financial risk management (contd)

40.6 Capital management (Contd.)

40.6.1 Quantative disclosures (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)	2019	2018
	Rs.'000	Rs.'000
Credit risk	296,511,881	296,029,229
Market risk	15,671,112	17,506,057
Operational risk	27,652,339	28,819,376
Total risk-weighted assets	339,835,332	342,354,662
Capital ratios (Audited)		
Tier 1 ratio	16.85%	15.16%
Total capital ratio	17.51%	15.47%

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

FOR THE YEAR ENDED 31 DECEMBER

41 Fair value of financial assets and liabilities

41.1 Fair value of financial instruments not carried at fair value

	2019	2019	2018	2018
Assets	Carrying value	Fair value	Carrying value	Fair value
Cash and cash equivalents	33,986,286	33,986,286	23,502,316	23,502,316
Balances with Central Bank	9,740,145	9,740,145	7,332,880	7,332,880
Placements with banks	27,214,500	27,214,500	49,385,700	49,385,700
Financial assets at amortised cost - loans and advances	260,155,127	262,843,879	255,830,603	257,276,343
Acceptances and endorsements	6,349,354	6,349,354	6,843,206	6,843,206
Liabilities				
Due to banks	170,599,897	170,599,897	184,786,888	184,786,888
Financial liabilities at amortised cost - due to depositors	209,805,122	209,805,122	205,873,323	205,873,323
Acceptances and endorsements	6,349,354	6,349,354	6,843,206	6,843,206

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.

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

FOR THE YEAR ENDED 31 DECEMBER

41 Fair value of financial assets and liabilities (contd)

41.2 Fair value of financial instruments carried at fair value

41.2.1 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 2019	Level 1 Rs'000	Level 2 Rs'000	Level 3 Rs'000
Assets			
Financial assets measured at fair value through profit or loss	-	4,751,028	-
Derivatives	5,057	807,064	-
Financial assets measured at fair value through other comprehensive income	-	90,628,547	17,226,007
Financial assets at amortised cost - debt instruments		3,088,314	
	<u>5,057</u>	<u>99,274,953</u>	<u>17,226,007</u>
Liabilities			
Derivatives	5,424	1,047,152	-
	<u>5,424</u>	<u>1,047,152</u>	<u>-</u>
As at 31 December 2018			
Assets			
Financial assets measured at fair value through profit or loss	-	11,516,593	-
Derivatives	3,226	4,463,528	-
Financial assets measured at fair value through other comprehensive income	-	100,949,137	-
Financial assets at amortised cost - debt instruments	-	5,308,259	-
	<u>3,226</u>	<u>122,237,517</u>	<u>-</u>
Liabilities			
Derivative financial instruments	1,207	3,874,641	-
	<u>1,207</u>	<u>3,874,641</u>	<u>-</u>

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

FOR THE YEAR ENDED 31 DECEMBER

41 Fair value of financial assets and liabilities (contd)

41.2 Fair value of financial instruments carried at fair value (contd)

41.2.1 Fair value hierarchy (contd)

Movement in Level 3 financial instruments	2019	
	Assets Rs'000	Liabilities Rs'000
As at 1 January	-	-
Additions	32,191,857	-
Settlements	(14,965,850)	-
As at 31 December	17,226,007	-

41.2.2 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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FOR THE YEAR ENDED 31 DECEMBER

41 Fair value of financial assets and liabilities (contd)

41.2 Fair value of financial instruments carried at fair value (contd)

41.2.2 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.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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SUPPLEMENTARY BASEL 111 DISCLOSURES

FOR THE YEAR ENDED 31 DECEMBER

42 Pillar III disclosures as per Basel III

1 Key Regulatory Ratios - Capital and Liquidity

Regulatory Capital Adequacy *	2019	2018
Common Equity Tier 1, Rs. '000	57,269,332	51,903,569
Tier 1 Capital, Rs. '000	57,269,332	51,903,569
Total Capital, Rs. '000	59,488,702	52,953,334
Common Equity Tier 1 Capital Ratio, as % of Risk Weighted Assets (Minimum Requirement, 7%)	16.85%	15.16%
Tier 1 Capital Ratio, as % of Risk Weighted Assets (Minimum Requirement, 8.5%)	16.85%	15.16%
Total Capital Ratio, as % of Risk Weighted Assets (Minimum Requirement, 12.5%)	17.51%	15.47%

	2019	2018
Regulatory Liquidity		
Statutory Liquid Assets, Rs.'000		
Domestic Banking unit	107,235,873	115,206,461
Off-Shore Banking Unit	77,675,082	70,115,622
Statutory Liquid Assets Ratio,% (Minimum Requirement, 20%)		
Domestic Banking Unit	50.14%	54.33%
Off-Shore Banking Unit	44.69%	39.38%
Liquidity Coverage Ratio (%) - Rupee (Minimum Requirement, 100%)	231.15%	150.18%
Liquidity Coverage Ratio (%) - All currency (Minimum Requirement, 100%)	360.57%	275.03%
Leverage Ratio (%) (Minimum Requirement 3%)	9.53%	8.45%
Net Stable Funding Ratio (%) (Minimum Requirement 100%)	121.44%	119.09%

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SUPPLEMENTARY BASEL 111 DISCLOSURES

FOR THE YEAR ENDED 31 DECEMBER

42 Pillar III disclosures as per Basel III (Contd.)

2 Computation of capital adequacy ratio

Item	Rs. '000
Common Equity Tier I (CETI) Capital after Adjustments	57,269,332
Total Common Equity Tier I (CET1) Capital	57,233,678
Equity capital or stated capital/assigned capital	3,152,358
Reserve fund	2,598,157
Published retained earnings/(accumulated retained losses)	43,141,527
Accumulated other comprehensive income (OCI)	5,203,062
General and other disclosed reserves	3,138,575
Total Adjustments to CET1 Capital	(35,654)
Amount due to head office & branches outside Sri Lanka in Sri Lanka Rupees	(35,654)
Tier 2 Capital after Adjustments	2,219,370
Total Tier 2 Capital	2,219,370
Revaluation gains	1,049,765
General provisions	1,169,605
Total Adjustments to Tier 2 Capital	-
Total Tier 1 Capital	57,269,332
Total Capital	59,488,702
Total Risk Weighted Assets (RWA)	339,835,332
RWAs for Credit Risk	296,511,881
RWAs for Market Risk	15,671,112
RWAs for Operational Risk	27,652,339
CET1 Capital Ratio (including Capital Conservation Buffer, Countercyclical Capital Buffer & Surcharge on D-SIBs) (%)	16.85%
of which: Capital Conservation Buffer (%)	1.25%
of which: Countercyclical Buffer (%)	
of which: Capital Surcharge on D-SIBs (%)	
Total Tier 1 Capital Ratio (%)	16.85%
Total Capital Ratio (including Capital Conservation Buffer, Countercyclical	17.51%
Capital Buffer & Surcharge on D-SIBs) (%)	
of which: Capital Conservation Buffer (%)	1.25%
of which: Countercyclical Buffer (%)	
of which: Capital Surcharge on D-SIBs (%)	

3 Computation of Leverage Ratio

Item	Amount in Rs.'000	
	2019	2018
Tier 1 Capital	50,097,072	44,114,425
Total Exposures	525,634,765	521,986,088
On Balance Sheet Items (Excluding Derivatives and Securities Financing Transactions, but including Collateral)	468,152,506	467,979,731
Derivative Exposures	2,434,714	8,570,101
Securities Financing Transaction Exposures		
Other Off-Balance Sheet Exposures	55,047,545	45,436,256
Basel III Leverage Ratio	9.53%	8.45%

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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SUPPLEMENTARY BASEL 111 DISCLOSURES

FOR THE YEAR ENDED 31 DECEMBER

42 Pillar III disclosures as per Basel III (Contd.)

4 Computation of Liquidity Coverage Ratio (All Currency)

Item	Rs.'000		Rs.'000	
	2019		2018	
	Total Un-weighted Value	Total Weighted Value	Total Un-weighted Value	Total Weighted Value
Total Stock of High-Quality Liquid Assets (HQLA)	79,343,979	79,078,821	57,360,923	57,360,923
Total Adjusted Level 1A Assets	79,343,979	79,343,979	57,307,146	57,307,146
Level 1 Assets	79,078,821	79,078,821	57,360,923	57,360,923
Total Adjusted Level 2A Assets	-	-	-	-
Level 2A Assets	-	-	-	-
Total Adjusted Level 2B Assets	-	-	-	-
Level 2B Assets	-	-	-	-
Total Cash Outflows	361,498,492	87,727,646	537,749,918	83,424,510
Deposits	107,351,212	10,735,121	104,820,995	10,482,100
Unsecured Wholesale Funding	124,316,603	58,174,109	140,386,559	54,754,820
Secured Funding Transactions	4,000,000	-	8,686,934	-
Undrawn Portion of Committed (Irrevocable) Facilities and Other Contingent Funding Obligations	114,631,185	7,618,924	268,946,657	3,278,817
Additional Requirements	11,199,492	11,199,492	14,908,773	14,908,773
Total Cash Inflows	74,931,778	72,594,388	121,215,816	74,219,611
Maturing Secured Lending Transactions Backed by Collateral Committed Facilities				
Other Inflows by Counterparty which are Maturing within 30 Days	51,249,544	66,247,142	82,923,001	66,154,351
Operational Deposits	11,293,272	-	22,970,952	-
Other Cash Inflows	12,388,962	6,347,246	15,321,863	8,065,260
Liquidity Coverage Ratio (%) (Stock of High Quality Liquid Assets/Total Net Cash Outflows over the Next 30 Calendar Days) * 100		360.57%		275.03%

5 Main Features of Regulatory Capital Instruments - N/A

6 Summary discussion on Adequacy/Meeting Current and Future Capital Requirements - Covered through note 40.6.1, capital management qualitative disclosures

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
SUPPLEMENTARY BASEL 111 DISCLOSURES

FOR THE YEAR ENDED 31 DECEMBER

42 Pillar III disclosures as per Basel III (Contd.)

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

Asset Class	Rs.'000					
	Exposures before Credit Conversion		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	125,445,644	12,700,100	125,445,644	471,718	6,332,842	5.03%
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	6,650,451	110,106,581	6,650,451	27,546,774	13,823,145	40.42%
Claims on Financial Institutions	2,300,000	1,725,044	2,300,000	53,518	1,176,759	50.00%
Claims on Corporates	210,613,409	198,352,071	210,310,636	30,104,141	231,398,836	96.25%
Retail Claims	45,796,209	48,971,840	38,700,889	69,704	29,311,904	75.60%
Claims Secured by Residential Property	2,871,793	-	2,871,793	-	2,871,793	100.00%
Claims Secured by Commercial Real Estate	-	-	-	-	-	-
Non-Performing Assets (NPAs)	358,639	-	358,639	-	366,112	102.08%
Higher-risk Categories	-	-	-	-	-	-
Cash Items and Other Assets	13,338,198	-	13,338,198	-	11,230,493	84.20%
Total	407,374,343	371,855,636	399,976,250	58,245,855	296,511,884	

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

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FOR THE YEAR ENDED 31 DECEMBER

42 Pillar III disclosures as per Basel III (Contd.)

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

Description	Rs.'000							Total Credit Exposures Amount
	0%	20%	50%	75%	100%	150%	>150%	
Risk Weight								
Asset classes								
Claims on Central Government and Central Bank of Sri Lanka	94,253,154	31,664,208	-	-	-	-	-	125,917,362
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	-	15,033,098	16,695,202	-	2,468,924	-	-	34,197,224
Claims on Financial Institutions	-	-	2,353,518	-	-	-	-	2,353,518
Claims on Corporates	-	9,946,707	2,117,152	-	228,350,919	-	-	240,414,778
Retail Claims	-	-	-	37,834,760	935,834	-	-	38,770,594
Claims Secured by Residential Property	-	-	-	-	2,871,793	-	-	2,871,793
Claims Secured by Commercial Real Estate	-	-	-	-	-	-	-	-
Non-Performing Assets (NPAs)	-	-	26,489	-	290,716	41,434	-	358,639
Higher-risk Categories	-	-	-	-	-	-	-	-
Cash Items and Other Assets	1,177,287	1,163,022	-	-	10,997,888	-	-	13,338,197
Total	95,430,441	57,807,035	21,192,361	37,834,760	245,916,074	41,434	-	458,222,104

Figures are subjected to credit conversion factors and credit risk mitigation

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42 Pillar III disclosures as per Basel III (Contd.)

9 Market risk under standardised measurement method

Item	Rs.'000
(a) RWA for Interest Rate Risk	15,362,544
General Interest Rate Risk	
(i) Net Long or Short Position	1,920,318
(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	308,568
Capital Charge for Market Risk [(a) + (b) + (c)] * CAR	1,920,318

10 Operational risk under basic indicator approach

	Capital Charge	Gross Income		
		Rs.'000		
	Factor	1st Year	2nd Year	3rd Year
The Basic Indicator Approach	15%	22,996,635	23,305,097	22,829,116
Capital Charges for Operational Risk (LKR'000)				
The Basic Indicator Approach	3,456,542			
Risk Weighted Amount for Operational Risk (LKR'000)				
The Basic Indicator Approach	27,652,339			

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42 Pillar III disclosures as per Basel III (Contd.)

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

Item	Rs.'000				
	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	33,986,286	11,307,536	7,182,163	3,653,774	4,125,373
Balances with Central Banks	7,940,145	7,940,145	7,940,145	-	-
Placements with Banks	27,214,500	49,893,250	-	21,771,600	28,121,650
Derivative Financial Instruments	812,121	812,121	655,074	-	157,047
Other Financial Assets Held-For-Trading	4,751,028	112,605,582	112,605,582	112,605,582	-
Financial Assets Designated at Fair Value through Profit or Loss	-	-	-	-	-
Loans and Receivables to Banks	1,800,000	1,800,000	1,800,000	-	-
Loans and Receivables to Other Customers	260,155,126	261,470,942	261,852,838	16,175,632	(1,368,196)
Financial Investments - Available-For-Sale	107,854,554	-	-	-	-
Financial Investments - Held-To-Maturity	3,088,314	3,102,047	3,102,047	3,102,047	-
Investments in Subsidiaries	-	-	-	-	-
Investments in Associates and Joint Ventures	-	-	-	-	-
Property, Plant and Equipment	5,212,836	5,212,867	5,212,836	-	-
Investment Properties	-	-	-	-	-
Goodwill and Intangible Assets	-	-	-	-	-
Deferred Tax Assets	-	-	-	-	-
Other Assets	14,517,472	7,023,625	7,023,625	932,233	-
Liabilities					
Due to Banks	170,599,897	170,599,896	-	28,733,939	141,865,957
Derivative Financial Instruments	1,052,576	1,052,576	-	945,784	106,792
Other Financial Liabilities Held-For-Trading	-	-	-	-	-
Financial Liabilities Designated at Fair Value Through Profit or Loss	-	-	-	-	-
Due to Other Customers	209,805,122	209,805,122	-	45,029,603	164,775,519
Other Borrowings	-	-	-	-	-
Retirement Benefit Obligations	79,212	-	-	-	-
Current Tax Liabilities	357,774	523,367	-	-	523,367
Deferred Tax Liabilities	366,422	-	-	-	-
Other Provisions	-	-	-	-	-
Other Liabilities	18,445,106	13,160,220	-	689,656	12,470,564
Due to Subsidiaries	-	-	-	-	-
Subordinated Term Debts	-	-	-	-	-
Off-Balance Sheet Liabilities					
Guarantees	75,178,198	75,178,198	75,178,198	-	-
Performance Bonds	15,827,296	15,827,296	15,827,296	-	-
Letters of Credit	10,797,359	10,797,359	10,797,359	-	-
Other Contingent Items	-	6,349,354	6,349,354	2,228,597	-
Undrawn Loan Commitments	171,421,356	171,421,356	171,421,356	-	-
Other Commitments	220,397,459	147,929,932	92,282,074	33,212,432	27,408,162
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	45,105,357	46,845,999	43,141,527		
Accumulated Other Comprehensive Income	10,169,739		5,203,062		
Statutory reserve fund	2,598,158	2,473,287	2,598,157		
Other Reserves	5,600,660	13,600,730	3,138,575		
Total Shareholders' Equity	66,626,271	66,072,375	57,233,678		

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 2019 computed based on Banking Act Direction No. 01 of 2016 - Capital requirements under Basel III

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43 D-SIB Assessment Exercise

Assessment exercise disclosed as required by the Banking Act Direction No. 10 of 2019 on Framework for dealing with domestic systemically important banks.

General Information

Bank only
Rs.'million

Size Indicator

Section 1 - Total Exposures

Total exposures measure	525,635
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Interconnectedness Indicators

Section 2 - Intra-Financial System Assets

a. Funds deposited with or lent to other financial institutions (including unused portion of committed lines extended)	2,065
(i) Funds deposited	265
(ii) Lending	1,800
b. Holdings of securities issued by other financial institutions	-
c. Net positive current exposure of securities financing transactions (SFTs) with other financial institutions	-
d. Over-the-counter (OTC) derivatives with other financial institutions that have a net positive mark to market value	317
Intra-financial system assets	2,382

Section 3 - Intra-Financial System Liabilities

a. Funds deposited by or borrowed from other financial institutions (including unused portion of committed lines obtained)	170,912
(i) Funds deposited	166,912
(ii) Borrowings	4,000
b. Net negative current exposure of securities financing transactions with other financial institutions	-
c. Over-the-counter derivatives with other financial institutions that have a net negative mark to market value	833
Intra-financial system liabilities	171,745

Section 4 - Securities Outstanding

Securities outstanding	-
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Substitutability/Financial Institution Infrastructure Indicators

Section 5 - Payments made in the reporting year (excluding intragroup payments)

Payments activity	9,421,884
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Section 6 - Assets Under Custody

Assets under custody	260,680
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Section 7 - Underwritten Transactions in Debt and Equity Markets

Underwriting activity	-
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Section 8 - Trading Volume

Trading volume	-
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Complexity indicators

Section 9 - Notional Amount of Over-the-Counter (OTC) Derivatives

OTC derivatives	100,809
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Section 10 - Level 2 Assets

Level 2 assets	-
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Section 11 - Trading and available for sale (AFS) securities

Trading and AFS securities	113,418
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Section 12 - Cross-Jurisdictional Liabilities

Foreign liabilities (excluding derivatives and local liabilities in local currency)	164,734
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Section 13 - Cross-Jurisdictional Claims

Foreign claims (excluding derivatives and intragroup claims)	52,783
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