(audited)
The Group's objective for managing capital is to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements at all times. The Group recognises the impact of different level of equity capital on shareholder returns and seeks to maintain a prudent balance between advantages and flexibility provided by a strong capital position and higher returns on equity through greater leverage.

An annual group capital plan is prepared and approved by the Board with the objectives of maintaining an optimal amount of capital and a suitable mix between different components of capital. The Group manages its own capital within the context of the approved annual capital plan, which determines level of risk-weighted asset ("RWA") growth as well as the optimal amount and components of capital required to support planned business growth. As part of the Group's capital management policy, subsidiary with capital generated in excess of planned requirement will return to the Bank, normally by way of dividends. The Group also raised subordinated debt in accordance with HSBC Group's guidelines regarding market and investor concentration, cost, market conditions, timing and maturity profile.

The Bank is primarily a provider of equity capital to its subsidiaries. These investments are substantially funded by the Bank's own capital and profit. The Bank seeks to maintain a prudent balance between the composition of its capital and that of its investment in subsidiaries.

The principal forms of capital are included in the following balances on the consolidated balance sheet: share capital, retained profits, other equity instruments and other reserves. Capital also includes impairment allowances and regulatory reserve for general banking risks as allowed under Banking (Capital) Rules.

Externally imposed capital requirements
(audited)

The HKMA supervises the Group on a consolidated and solo-consolidated basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, the Group as a whole. Individual banking subsidiaries are directly regulated by their local banking supervisors, who set and monitor their capital adequacy requirements. Certain non-banking financial subsidiaries are also subject to the supervision and capital requirements of local regulatory authorities.

The Group uses the advanced internal ratings-based approach ("IRB") to calculate its credit risk for the majority of its non-securitisation exposures. For market risk, the Group uses an internal models approach to calculate its general market risk for the risk categories of interest rate and foreign exchange (including gold) exposures and the standardised (market risk) approach for calculating other market risk positions. For operational risk, the Group uses the standardised (operational risk) approach to calculate its operational risk.

During the year, the Group has complied with all of the externally imposed capital requirements by the HKMA.

Basel III

(unaudited)

The Basel III capital rules set out the minimum CET1 capital requirement of 4.5% and total capital requirement of 8%.

The Banking (Capital) (Amendment) Rules 2014 came into effect on 1 January 2015 to implement the Basel III capital buffer requirements in Hong Kong. The changes include the phasing-in from 2016 to 2019 of the Capital Conservation Buffer ("CCB") which is designed to ensure banks build up capital outside periods of stress of 2.5% of RWAs, the Countercyclical Capital Buffer ("CCyB") which is set on an individual country basis and is built up during periods of excess credit growth to protect against future losses, and the Higher Loss Absorbency ("HLA") requirements for Domestic Systemically Important Banks ("D-SIB"). The CCyB for Hong Kong is 1.25% RWAs from 1 January 2017, 1.875% from 1 January 2018 and 2.5% from 1 January 2019. The increase follows the Basel III phase-in arrangement for the CCyB. On 16 March 2015, the HKMA announced the designation of the Bank as a D-SIB and the HLA requirement to be 1.5% of RWAs which will be phased-in from 0.375% in 2016 to reach the full implementation in 2019. On 21 December 2018, the HKMA confirmed the designation of the Bank as a D-SIB as well as the HLA requirements.

Loss-Absorbing Capacity Requirements

(unaudited)

In November 2014, as part of the "too big to fail" agenda, the Financial Stability Board ("FSB") published proposals for Total Loss-absorbing Capacity ("TLAC") for Global Systemically Important Banks ("G-SIBs"). In November 2015, the FSB issued its final term sheet on TLAC which set the minimum TLAC requirement to be 16% of RWAs from 1 January 2019, rising to 18% from 1 January 2022. In addition, there must be sufficient TLAC to meet a leverage ratio requirement of 6% from 1 January 2019, rising to 6.75% by 1 January 2022.

In December 2018, the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules ("LAC") in Hong Kong were passed into legislation, with transition periods provided for their implementation. As the Bank is a member of HSBC Group which was designated as a G-SIB by FSB, the LAC requirements are expected to be implemented in 2019 for the Group.

Leverage ratio

(unaudited)

The leverage ratio was introduced into the Basel III framework as a non-risk-based backstop limit, to supplement risk-based capital requirements. It aims to constrain the build-up of excess leverage in the banking sector, introducing additional safeguards against model risk and measurement errors. The ratio is a volume-based measure calculated as Basel III tier 1 capital divided by total on- and off-balance sheet exposures. Basel III provides for a transitional period for the introduction of this ratio, comprising a supervisory monitoring period that started in 2011 and a parallel run period from January 2013 and completed by 2017. The Banking (Capital) (Amendment) Rules 2017 came into effect on 1 January 2018. This includes the implementation of the leverage ratio framework in Hong Kong with the minimum leverage ratio requirement of 3%.

Capital base

(unaudited)

The following tables show the capital base, RWAs and capital ratios as contained in the "Capital Adequacy Ratio" return required to be submitted to the HKMA by the Bank on consolidated basis as specified by the HKMA under the requirements of section 3C(1) of the Banking (Capital) Rules. The basis is different from that for accounting purposes. Further information on the regulatory consolidation basis is set out in the Banking Disclosure Statement that is available in the Regulatory Disclosures section of our website www.hangseng.com.

The Bank and its subsidiaries maintain a regulatory reserve to satisfy the provisions of the Banking Ordinance and local regulatory requirements for prudential supervision purposes. At 31 December 2018, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK$4,982 million (2017: HK$6,018 million).

Capital base continued

(unaudited)

The following table sets out the composition of the Group's capital base under Basel III at 31 December 2018 and 31 December 2017. A more detailed breakdown of the capital position and a full reconciliation between the Group's accounting and regulatory balance sheets can be viewed in the Banking Disclosure Statement in the Regulatory Disclosures section of our website www.hangseng.com.

	2018	2017
Common Equity Tier 1 ("CET1") Capital		
Shareholders' equity	133,990	126,241
– Shareholders' equity per consolidated balance sheet	162,082	152,030
– Additional Tier 1 ("AT1") perpetual capital instrument	(6,981)	(6,981)
– Unconsolidated subsidiaries	(21,111)	(18,808)
Non-controlling interests	–	–
– Non-controlling interests per consolidated balance sheet	25	49
– Non-controlling interests in unconsolidated subsidiaries	(25)	(49)
Regulatory deductions to CET1 capital	(32,266)	(31,783)
– Cash flow hedging reserve	4	41
– Changes in own credit risk on fair valued liabilities	(12)	(5)
– Property revaluation reserves[1]	(26,543)	(24,842)
– Regulatory reserve	(4,982)	(6,018)
– Intangible assets	(463)	(408)
– Defined benefit pension fund assets	(11)	(45)
– Deferred tax assets net of deferred tax liabilities	(111)	(211)
– Valuation adjustments	(148)	(295)
Total CET1 Capital	101,724	94,458
AT1 Capital		
Total AT1 capital before and after regulatory deductions	6,981	6,981
– Perpetual capital instrument	6,981	6,981
Total AT1 Capital	6,981	6,981
Total Tier 1 ("T1") Capital	108,705	101,439
Tier 2 ("T2") Capital		
Total T2 capital before regulatory deductions	15,517	14,723
– Property revaluation reserves1	11,944	11,179
– Impairment allowances and regulatory reserve eligible for inclusion in T2 capital	3,573	3,544
Regulatory deductions to T2 capital	(915)	(915)
– Significant capital investments in unconsolidated financial sector entities	(915)	(915)
Total T2 Capital	14,602	13,808
Total Capital	123,307	115,247

1 Includes the revaluation surplus on investment properties which is reported as part of retained profits and related adjustments made in accordance with the Banking (Capital) Rules issued by the HKMA.

Risk-weighted assets by risk type
(unaudited)

	2018	2017
Credit risk	541,542	512,720
Market risk	11,020	7,208
Operational risk	59,323	52,795
Total	611,885	572,723

Capital ratios (as a percentage of risk-weighted assets)
(unaudited)

The capital ratios on consolidated basis calculated in accordance with the Banking (Capital) Rules are as follows:

	2018	2017
CET1 capital ratio	16.6%	16.5%
T1 capital ratio	17.8%	17.7%
Total capital ratio	20.2%	20.1%

On a pro-forma basis that takes no account of, for example, any future profits or management action and any change in the current regulations or their application before full implementation, the Group's capital ratios at Basel III end point are the same as above as at 31 December 2018. Given the pro-forma Basel III end point basis position is a mechanical application of the current rules to the capital base as at 31 December 2018, it is not a projection.

In addition, the capital ratios of all tiers as of 31 December 2018 would be reduced by approximately 1.1 percentage point after the prospective fourth interim dividend payment for 2018. The following table shows the pro-forma basis position of the capital ratios after the prospective interim dividend.

	Pro-forma 2018	Pro-forma 2017
CET1 capital ratio	15.5%	15.5%
T1 capital ratio	16.6%	16.7%
Total capital ratio	19.0%	19.1%

Leverage ratio
(unaudited)

	2018	2017
Leverage ratio	7.4%	7.3%
T1 capital	108,705	101,439
Exposure measure	1,477,001	1,388,288

Detailed breakdown of the Group's leverage exposure measure and a summary comparison table reconciling the assets of the Group's accounting balance sheet with the leverage exposure measure using the standard templates as specified by the HKMA can be viewed in the Banking Disclosure Statement in the Regulatory Disclosures section of our website www.hangseng.com.

Other financial information
Other financial information required under the Banking (Disclosure) Rules can be viewed in the Banking Disclosure Statement that is available in the Regulatory Disclosures section of our website www.hangseng.com.