HSBC Savings Bank (Philippines), Inc.

(A wholly-owned subsidiary of the Philippine Branch of The Hongkong and Shanghai Banking Corporation Limited)

Financial Statements
As at and for the years ended December 31, 2018 and 2017

Independent Auditor's Report

To the Board of Directors and Shareholder of
HSBC Savings Bank (Philippines), Inc.
(A wholly-owned subsidiary of the Philippine Branch of
The Hongkong and Shanghai Banking Corporation Limited)
Unit 1 GF The Commercial Complex, Madrigal Avenue,
Ayala Alabang Village
Muntinlupa City

Report on the Audits of the Financial Statements

Our Opinion

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of HSBC Savings Bank (Philippines), Inc. (the "Bank") as at December 31, 2018 and 2017, and its financial performance and its cash flows for the years then ended in accordance with Philippine Financial Reporting Standards (PFRSs).

What we have audited

The financial statements of the Bank comprise:

- the statements of financial position as at December 31, 2018 and 2017;
- the statements of income for the years ended December 31, 2018 and 2017;
- the statements of total comprehensive income for the years ended December 31, 2018 and 2017;
- the statements of changes in equity for the years ended December 31, 2018 and 2017;
- the statements of cash flows for the years ended December 31, 2018 and 2017; and
- the notes to the financial statements, which include a summary of significant accounting policies.

Basis for Opinion

We conducted our audits in accordance with Philippine Standards on Auditing (PSAs). 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 Bank in accordance with the Code of Ethics for Professional Accountants in the Philippines (Code of Ethics), together with the ethical requirements that are relevant to our audit of the financial statements in the Philippines, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics.

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Other Information

Management is responsible for the other information. The other information comprises the information included in the Annual Report for the year ended December 31, 2018, but does not include the financial statements and our auditor's report thereon. The Annual Report is expected to be made available to us after the date of this auditor's report.

Our opinion on the financial statements does not cover the other information and we 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 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.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with PFRSs, 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 Bank'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 Bank or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank'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 PSAs 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 PSAs, 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 Bank'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 ability of the Bank 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 Bank 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.

Report on Bureau of Internal Revenue Requirement

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information in Note 27 to the financial statements is presented for purposes of filing with the Bureau of Internal Revenue and is not a required part of the basic financial statements. Such supplementary information is the responsibility of management and has been subjected to the auditing procedures applied in our audits of the basic financial statements. In our opinion, the supplementary information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Isla Lipana & Co.

John-John Patrick V. Lim
Partner
CPA Cert. No. 83389
P.T.R. No. 0007706, issued on January 8, 2019, Makati City
SEC A.N. (individual) as general auditors PA-A-836-A, Category A; effective until August 3, 2019
SEC A.N. (firm) as general auditors 0009-FR-5, Category A; effective until June 20, 2021
TIN 112-071-386
BIR A.N. 08-000745-017-2018, issued on December 10, 2018; effective until December 9, 2021
BOA/PRC Reg. No. 0142, effective until September 30, 2020

Makati City
April 25, 2019

Contents

HSBC Savings Bank (Philippines), Inc.
(A wholly-owned subsidiary of the Philippine Branch of
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Statements of Financial Position
December 31, 2018 and 2017
(In thousands of Philippine Peso)

	Notes	2018	2017
A S S E T S			
CASH AND OTHER CASH ITEMS	7	197,666	168,148
DUE FROM BANGKO SENTRAL NG PILIPINAS	7,8	913,800	3,698,433
DUE FROM OTHER BANKS	7	1,337,086	1,848,574
INTERBANK LOANS RECEIVABLE AND SECURITIES PURCHASED UNDER RESALE AGREEMENTS	7,8	631,877	417,919
FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS (FVTPL)	9	15	7
FINANCIAL ASSETS AT FAIR VALUE THROUGH OTHER COMPREHENSIVE INCOME (FVOCI)	10	7,906,317	N/A
AVAILABLE-FOR-SALE (AFS) FINANCIAL ASSETS	10	N/A	6,344,394
LOANS AND RECEIVABLES, net	11	2,490,458	2,752,564
PROPERTY AND EQUIPMENT, net	12	12,744	14,871
DEFERRED TAX ASSETS, net	23	60,352	29,857
OTHER ASSETS, net	13	78,356	83,397
Total assets		13,628,671	15,358,164
LIABILITIES AND EQUITY			
DEPOSIT LIABILITIES	15		
Demand		2,530,874	3,045,413
Savings		7,397,525	7,888,777
Time		1,782,533	2,444,431
		11,710,932	13,378,621
FINANCIAL LIABILITIES AT FAIR VALUE THROUGH PROFIT OR LOSS	9	4	17
BILLS PAYABLE	16	79,750	30,307
CASHIER'S ORDERS		40,512	53,429
ACCRUED EXPENSES AND OTHER LIABILITIES	17	109,043	132,049
Total liabilities		11,940,241	13,594,423
EQUITY			
Share capital	18	1,492,000	1,492,000
Other reserves	20	10,915	10,915
Retained earnings	18		
Appropriated		20,750	-
Unappropriated		305,824	316,192
Net unrealised losses on financial assets at FVOCI, net of tax	10	(85,499)	N/A
Net unrealised losses on AFS financial assets, net of tax	10	N/A	(11,762)
Remeasurement losses on retirement plan	19	(59,666)	(43,604)
Cumulative translation adjustment		4,106	-
Total equity		1,688,430	1,763,741
Total liabilities and equity		13,628,671	15,358,164

(The notes on pages 1 to 77 are an integral part of these financial statements.)

HSBC Savings Bank (Philippines), Inc.
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Statements of Income
For the years ended December 31, 2018 and 2017
(In thousands of Philippine Peso)

	Notes	2018	2017
INTEREST INCOME			
Loans and receivables		229,361	243,530
Investment securities	10	212,871	112,785
Due from Bangko Sentral ng Pilipinas and other banks		70,350	154,957
		512,582	511,272
INTEREST EXPENSE			
Deposit liabilities	15	10,066	11,528
Bills payable		1,038	284
		11,104	11,812
NET INTEREST INCOME		501,478	499,460
NET FEES AND COMMISSION INCOME			
Fees and commission income	22	34,608	43,373
Fees and commission expense		21,737	9,188
		12,871	34,185
OTHER INCOME			
Foreign exchange profit, net		23,711	37,944
Trading losses, net		(23,507)	(744)
Other operating income		7,994	4,276
		8,198	41,476
TOTAL OPERATING INCOME BEFORE LOAN IMPAIRMENT CHARGES		522,547	575,121
CREDIT AND IMPAIRMENT LOSSES	14	9,529	15,397
NET OPERATING INCOME		513,018	559,724
OPERATING EXPENSES			
Compensation and personnel-related costs		112,360	121,342
Occupancy and equipment-related costs		101,735	112,107
Taxes and licenses		44,115	43,137
Depreciation and amortisation	12	6,071	4,161
Other operating expenses	22	76,183	111,060
		340,464	391,807
INCOME BEFORE INCOME TAX		172,554	167,917
INCOME TAX EXPENSE	23	39,620	55,987
NET INCOME FOR THE YEAR		132,934	111,930

(The notes on pages 1 to 77 are an integral part of these financial statements.)

HSBC Savings Bank (Philippines), Inc.
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Statements of Total Comprehensive Income
For the years ended December 31, 2018 and 2017
(In thousands of Philippine Peso)

	Notes	2018	2017
NET INCOME FOR THE YEAR		132,934	111,930
OTHER COMPREHENSIVE LOSS			
Item that may not be reclassified to profit or loss			
Changes in remeasurement (losses) gains on retirement plan, net of tax	19	(16,062)	12,653
Items that may be reclassified to profit or loss			
Changes in net unrealised losses on financial assets at FVOCI, net of tax	10	(74,353)	N/A
Changes in net unrealised losses on AFS financial assets, net of tax	10	N/A	(12,663)
Net movement in cumulative translation adjustment		4,106	-
		(86,309)	(10)
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		46,625	111,920

(The notes on pages 1 to 77 are an integral part of these financial statements.)

HSBC Savings Bank (Philippines), Inc.
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Statements of Changes in Equity
For the years ended December 31, 2018 and 2017
(In thousands of Philippine Peso)

	Share capital (Note 18)	Other reserves (Note 20)	Retained earnings (Note 18) Appropriated	Unappropriated	Net unrealised losses on financial assets at FVOCI, net of tax (Note 10)	Net unrealised losses on AFS financial assets, net of tax (Note 10)	Remeasurement losses on retirement plan, net of tax (Note 19)	Cumulative translation adjustment	Total
Balance at January 1, 2018	1,492,000	10,915	-	316,192	(11,762)	N/A	(43,604)	-	1,763,741
Impact of PFRS 9 adoption (Note 3)	-	-	-	(7,552)	616	-	-	-	(6,936)
Balance at January 1, 2018, as restated	1,492,000	10,915	-	308,640	(11,146)	N/A	(43,604)	-	1,756,805
Total comprehensive income			-						
Net income for the year	-	-	-	132,934	-	-	-	-	132,934
Other comprehensive loss									
Changes in remeasurement losses on retirement plan	-	-	-	-	-	-	(16,062)	-	(16,062)
Changes in fair value of financial assets at FVOCI	-	-	-	-	(74,353)	N/A	-	-	(74,353)
Net movement in cumulative translation adjustment	-	-	-	-	-	-	-	4,106	4,106
Total comprehensive income for the year	-	-	-	132,934	(74,353)	N/A	(16,062)	4,106	46,625
Transactions with owner of the Bank									
Dividends declared (Note 18)	-	-	-	(115,000)	-	-	-	-	(115,000)
Appropriation of retained earnings	-	-	20,750	(20,750)	-	-	-	-	-
Balance at December 31, 2018	1,492,000	10,915	20,750	305,824	(85,499)	N/A	(59,666)	4,106	1,688,430

(The notes on pages 1 to 77 are an integral part of these financial statements.)

HSBC Savings Bank (Philippines), Inc.
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Statements of Changes in Equity
For the years ended December 31, 2018 and 2017
(In thousands of Philippine Peso)

	Share capital (Note 18)	Other reserves (Note 20)	Retained earnings (Note 18)		Net unrealised losses on financial assets at FVOCI, net of tax (Note 10)	Net unrealised losses on AFS financial assets, net of tax (Note 10)	Remeasurement losses on retirement plan, net of tax (Note 19)	Cumulative translation adjustment	Total
			Appropriated	Unappropriated					
Balance at January 1, 2017	1,492,000	10,930	-	430,262	N/A	901	(56,257)	-	1,877,836
Total comprehensive income			-						
Net income for the year	-	-	-	111,930	-	-	-	-	111,930
Other comprehensive loss									
Changes in remeasurement losses on retirement plan	-	-	-	-	-	-	12,653	-	12,653
Changes in fair value of financial assets at FVOCI	-	-	-	-	-	N/A	-	-	N/A
Changes in fair value of AFS financial assets					N/A	(12,403)	-	-	(12,403)
Changes in fair value of AFS financial assets taken to profit or loss	-	-	-	-	N/A	(260)	-	-	(260)
Net movement in cumulative translation adjustment	-	-	-	-	-	-	-	-	-
Total comprehensive income for the year	-	-	-	111,930	N/A	(12,663)	12,653	-	111,920
Transactions with owner of the Bank									
Dividends declared (Note 18)	-	-	-	(226,000)	-	-	-	-	(226,000)
Movement in respect of share-based payment arrangements	-	(15)	-	-	-	-	-	-	(15)
Balance at December 31, 2017	1,492,000	10,915	-	316,192	N/A	(11,762)	(43,604)	-	1,763,741

(The notes on pages 1 to 77 are an integral part of these financial statements.)

HSBC Savings Bank (Philippines), Inc.
(A wholly-owned subsidiary of the Philippine Branch of
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Statements of Cash Flows
For the years ended December 31, 2018 and 2017
(In thousands of Philippine Peso)

	Notes	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES			
Income before income tax		172,554	167,917
Adjustments for:			
Amortisation of discount on financial assets at FVOCI		(889,961)	N/A
Amortisation of premium on AFS financial assets		N/A	43,263
Credit and impairment losses	14	9,529	15,397
Depreciation and amortisation	12	6,071	4,161
Share-based payment expense	20	-	(15)
Operating (loss) income before changes in operating assets and liabilities		(701,807)	230,723
Changes in operating assets and liabilities			
(Increase) decrease in:			
Financial assets at fair value through profit or loss		(8)	(7)
Loans and receivables		242,620	55,676
Other assets		(11,021)	16,909
Increase (decrease) in:			
Deposit liabilities		(1,665,289)	(1,293,028)
Financial liabilities at fair value through profit or loss		(13)	17
Cashier's orders		(12,917)	(591)
Accrued expenses and other liabilities		(22,763)	(17,244)
Net cash used in operations		(2,171,198)	(1,007,545)
Income taxes paid		(67,122)	(54,026)
Net cash used in operating activities		(2,238,320)	(1,061,571)
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchases of financial assets at FVOCI		(14,026,595)	N/A
Purchases of AFS financial assets		N/A	(7,915,672)
Proceeds from sale of financial assets at FVOCI		619,371	N/A
Proceeds from sale of AFS financial assets		N/A	343,799
Proceeds from maturity of financial assets at FVOCI		12,662,595	N/A
Proceeds from maturity of AFS financial assets		N/A	6,534,157
Acquisitions of property and equipment	12	(3,944)	(8,155)
Net cash used in investing activities		(748,573)	(1,045,871)
CASH FLOWS FROM FINANCING ACTIVITIES			
Increase (decrease) in bills payable		49,443	(260,107)
Dividends paid	18	(115,000)	(226,000)
Net cash used in financing activities		(65,557)	(486,107)
NET DECREASE IN CASH AND CASH EQUIVALENTS		(3,052,450)	(2,593,549)

(forward)

(The notes on pages 1 to 77 are an integral part of these financial statements.)

HSBC Savings Bank (Philippines), Inc.
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Statements of Cash Flows
For the years ended December 31, 2018 and 2017
(In thousands of Philippine Peso)

	Note	2018	2017
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	7		
Cash and other cash items		168,148	139,176
Due from Bangko Sentral ng Pilipinas		3,698,433	5,117,828
Due from other banks		1,848,574	1,966,168
Interbank loans receivable and SPURA		417,919	1,503,451
Allowance for credit and impairment losses		(195)	N/A
		6,132,879	8,726,623
CASH AND CASH EQUIVALENTS AT END OF YEAR	7		
Cash and other cash items		197,666	168,148
Due from Bangko Sentral ng Pilipinas		913,800	3,698,433
Due from other banks		1,337,136	1,848,574
Interbank loans receivable and SPURA		631,881	417,919
Allowance for credit and impairment losses		(54)	N/A
		3,080,429	6,133,074
NET OPERATIONAL CASH FLOWS FROM INTEREST			
Interest received		504,257	519,756
Interest paid		10,212	11,966

(The notes on pages 1 to 77 are an integral part of these financial statements.)

1 General information

HSBC Savings Bank (Philippines), Inc. (the "Bank") is a thrift bank incorporated in the Philippines. It is a wholly-owned subsidiary of the Philippine Branch of The Hongkong and Shanghai Banking Corporation Limited (the "Parent Company"). Through its network of three (3) branches, the Bank provides a comprehensive range of financial services primarily to individual clients. The Bank's principal banking products and services include deposits, lending and related services. Its principal place of business is at Unit 1 GF The Commercial Complex, Madrigal Avenue, Ayala Alabang Village, Muntinlupa City, Philippines.

The Hongkong and Shanghai Banking Corporation Limited (HSBC) is incorporated in Hong Kong and the Ultimate Parent Company of the Philippine Branch and its subsidiaries (the "Group") is HSBC Holdings PLC (the "Ultimate Parent Company") which is headquartered in London.

These financial statements have been authorised for issue by the Board of Directors (BOD) of the Bank on April 25, 2019.

2 Basis of preparation

The financial statements of the Bank have been prepared in accordance with Philippine Financial Reporting Standards (PFRSs). The term PFRSs in general includes all applicable PFRSs, Philippine Accounting Standards (PASs), and interpretations of the Philippine Interpretations Committee (PIC), Standing Interpretations Committee (SIC) and International Financial Reporting Interpretations Committee (IFRIC) which have been approved by the Financial Reporting Standards Council (FRSC) and adopted by the Securities and Exchange Commission (SEC).

The financial statements of the Bank have been prepared using historical cost basis of accounting, except for financial assets and financial liabilities at FVTPL, financial assets at FVOCI, AFS financial assets, and the plan assets component of retirement liability which are measured at fair value.

The accompanying financial statements include the accounts maintained in the Regular Banking Unit (RBU) and Foreign Currency Deposit Unit (FCDU) of the Bank. Individual financial statements for these units are combined after eliminating inter-unit accounts.

The functional currency of the RBU and FCDU is Philippine peso (PHP) and United States Dollar (USD), respectively. For financial reporting purposes, FCDU accounts and foreign currency-denominated accounts in the RBU are translated to their equivalents in PHP (Note 5.1).

The preparation of financial statements in conformity with PFRSs requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Bank's accounting policies. Changes in assumptions may have a significant impact on the financial statements in the period the assumptions changed. Management believes that the underlying assumptions are appropriate and that the financial statements therefore fairly present the financial position and results of the Bank. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 4.

2.1 Changes in accounting policy and disclosures

(a) New standards adopted by the Bank

The following new standards have been adopted by the Bank effective January 1, 2018:

- *PFRS 9, 'Financial Instruments'* is a comprehensive standard that replaced PAS 39, 'Financial Instruments: Recognition and Measurement', and includes requirements for classification and measurement of financial assets and liabilities, impairment of financial assets and hedge accounting.

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

  The impact of the adoption of PFRS 9 and the new accounting policies are disclosed in Notes 3 and 5.2, respectively.

- *PFRS 15, 'Revenue from contracts with customers'* replaces PAS 18, 'Revenue' which covers contracts for goods and services and PAS 11, 'Construction contracts' which covers construction contracts. The new standard is based on the principle that revenue is recognised when control of a good or service transfers to a customer - so the notion of control replaces the existing notion of risks and rewards. A new five-step process must be applied before revenue can be recognised: (1) identify contracts with customers, (2) identify the separate performance obligation, (3) determine the transaction price of the contract, (4) allocate the transaction price to each of the separate performance obligations, and (5) recognise the revenue as each performance obligation is satisfied. Key changes to current practice are: (1) Any bundled goods or services that are distinct must be separately recognised, and any discounts or rebates on the contract price must generally be allocated to the separate elements; (2) Revenue may be recognised earlier than under current standards if the consideration varies for any reasons (such as for incentives, rebates, performance fees, royalties, and success of an outcome) - minimum amounts must be recognised if they are not at significant risk of reversal; (3) The point at which revenue is able to be recognised may shift: some revenue which is currently recognised at a point in time at the end of a contract may have to be recognised over the contract term and vice versa; (4) There are new specific rules on licenses, warranties, non-refundable upfront fees and, consignment arrangements, to name a few; and (5) As with any new standard, there are also increased disclosures. These accounting changes may have flow-on effects on the entity's business practices regarding systems, processes and controls, compensation and bonus plans, contracts, tax planning and investor communications. The standard is effective for annual periods beginning on or after January 1, 2018 and earlier application is permitted. Entities will have a choice of full retrospective application, or prospective application with additional disclosures.

  The adoption of PFRS 15 did not have any significant impact on the financial statements as the Bank's revenues arise largely from financial instruments under PFRS 9 and is therefore outside the scope of PFRS 15. There is no material difference in revenue recognition under PAS 18 and the new revenue standard.

Other standards, amendments and interpretations which are effective for the financial year beginning on January 1, 2018 are considered not relevant to the Bank.

(b) New standard and interpretations not yet adopted

A number of new standards and amendments to standards and interpretations are effective for annual periods beginning after January 1, 2018, and have not been applied in preparing these financial statements. None of these standards are considered relevant or applicable to the Bank, except the following as set out below:

- *PFRS 16, 'Leases'* was issued in January 2017. It will result in almost all leases being recognised in the statement of financial position, as the distinction between operating and finance leases is removed. Under the new standard, an asset (the right to use the leased item) and a financial liability to pay rentals are recognised. The only exceptions are short- term and low-value leases. The accounting for lessors will not significantly change.

  The standard will affect primarily the accounting for operating leases. The Bank has assessed that the new standard will have an impact on the right-of-use assets and lease liabilities.

  Transitional impact

  PFRS 16 'Leases' has an effective date for annual periods beginning on or after January 1, 2019. PFRS 16 results in lessees accounting for most leases within the scope of the standard in a manner similar to the way in which finance leases are currently accounted for under PAS 17 'Leases'. Lessees will recognise a right-of-use (ROU) asset and a corresponding financial liability on the balance sheet. The asset will be amortised over the length of the lease, and the financial liability measured at amortised cost. Lessor accounting remains substantially the same as under PAS 17. The Bank expects to adopt the standard using a modified retrospective approach where the cumulative effect of initially applying it is recognised as an adjustment to the opening balance of retained earnings and comparatives are not restated. The implementation is expected to increase assets and financial liabilities by the same amount with no effect on equity.

- *Philippine Interpretation IFRIC-23, Uncertainty over Income Tax Treatments (effective for annual periods beginning on or after January 1, 2019).* It has been clarified previously that PAS 12, not PAS 37, Provisions, Contingent Liabilities and Contingent Assets, applies to accounting for uncertain income tax treatments. IFRIC 23 explains how to recognise and measure deferred and current income tax assets and liabilities where there is uncertainty over a tax treatment.

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

There are no other standards, amendments or interpretations that are not yet effective that have a material impact on the financial statements of the Bank.

3 Impact of PFRS 9 adoption

3. 1 Changes in accounting policies

The adoption of PFRS 9 resulted in changes in accounting policies and adjustments to the amounts previously recognised in the financial statements. The Bank did not early adopt any provisions of PFRS 9 in previous periods.

As permitted by the transitional provisions of PFRS 9, the Bank elected not to restate comparative figures. Resulting adjustments to the carrying amounts of financial assets and liabilities at the date of transition were recognised in the balance of retained earnings in equity as of January 1, 2018.

The adoption of PFRS 9 has resulted in changes mainly in the Bank's accounting policies for recognition, classification and measurement and impairment of financial assets. There were no changes in the classification of financial liabilities. PFRS 9 also significantly amends other standards dealing with financial instruments such as PFRS 7, Financial Instruments: Disclosures.

The Bank shifted from incurred loss model under PAS 39 to expected credit loss model in the determination of impairment provisions for financial assets not carried at fair value through profit or loss upon adoption of PFRS 9.

A reconciliation of presentational and measurement differences resulting from the adoption of PFRS 9 at January 1, 2018 is set out in Note 3.2.

Classification and measurement of financial assets

The measurement category and the carrying amount of financial assets in accordance with PAS 39 and PFRS 9 at January 1, 2018 follow:

	PAS 39		PFRS 9	
	December 31, 2017		January 1, 2018	
Financial instruments	Measurement category	Carrying amount	Measurement category	Carrying amount
Cash and other cash items	Amortised cost	168,148	Amortised cost	168,148
Due from Bangko Sentral ng Pilipinas	Amortised cost	3,698,433	Amortised cost	3,698,433
Due from other banks	Amortised cost	1,848,574	Amortised cost	1,848,379
Interbank loans and receivables and securities under resale agreements	Amortised cost	417,919	Amortised cost	417,919
Financial assets at FVTPL	FVTPL	7	FVTPL	7
AFS financial assets	AFS	6,344,394	FVOCI	6,344,394
Loans and receivables, net	Amortised cost	2,752,564	Amortised cost	2,742,587
Other financial assets	Amortised cost	15,066	Amortised cost	15,066

3.2 Effect of reclassification upon adoption of PFRS 9

3.2.1 Reconciliation of statement of financial position at December 31, 2017 and January 1, 2018

	PAS 39 carrying amount at December 31, 2017	PFRS 9 reclassification	Carrying amount post reclassification	PFRS 9 remeasurement	PFRS 9 carrying amount at January 1, 2018
Cash and other cash items	168,148	-	168,148	-	168,148
Due from Bangko Sentral ng Pilipinas	3,698,433	-	3,698,433	-	3,698,433
Due from other banks	1,848,574	-	1,848,574	(195)	1,848,379
Interbank loans and receivables and securities purchased under resale agreements	417,919	-	417,919	-	417,919
Financial assets at FVTPL	7	-	7	-	7
AFS financial assets	6,344,394	(6,344,394)	-	-	-
Financial assets at FVOCI	-	6,344,394	6,344,394	-	6,344,394
Loans and receivables, net	2,752,564	-	2,752,564	(9,977)	2,742,587
Property and equipment, net	14,871	-	14,871	-	14,871
Deferred tax assets, net	29,857	-	29,857	3,236	33,093
Other assets, net	83,397	-	83,397	-	83,397
Total assets	15,358,164	-	15,358,164	(6,936)	15,351,228
Deposit liabilities	13,378,621	-	13,378,621	-	13,378,621
Financial liabilities at FVTPL	17	-	17	-	17
Bills payable	30,307	-	30,307	-	30,307
Cashier's orders	53,429	-	53,429	-	53,429
Accrued expenses and other liabilities	132,049	-	132,049	-	132,049
Total liabilities	13,594,423	-	13,594,423	-	13,594,423
Share capital	1,492,000	-	1,492,000	-	1,492,000
Other reserves	10,915	-	10,915	-	10,915
Retained earnings Unappropriated	316,192	-	316,192	(7,552)	308,640
Net unrealised losses on financial assets at FVOCI, net of tax	-	(11,762)	(11,762)	616	(11,146)
Net unrealised losses on available-for-sale financial assets, net of tax	(11,762)	11,762	-	-	-
Remeasurement losses on retirement plan, net of tax	(43,604)	-	(43,604)	-	(43,604)
Total equity	1,763,741	-	1,763,741	(6,936)	1,756,805

3.2.2 Reconciliation of allowance for credit and impairment losses under PAS 39 to expected credit losses under PFRS 9

	PAS 39 amount at December 31, 2017	Remeasurement	PFRS 9 amount at January 1, 2018
Due from other banks	-	195	195
Loans and receivables	13,500	9,977	23,477
	13,500	10,172	23,672

Following the adoption of PFRS 9 on January 1, 2018, the Bank recognised credit and impairment loss on its financial assets at FVOCI amounting to P616. The related impairment amount is presented within the "Net unrealised losses on financial assets at FVOCI, net of tax" in the statement of financial position.

4 Critical accounting estimates and judgments

The preparation of financial information requires the use of estimates and judgments about future conditions. In view of the inherent uncertainties and the high level of subjectivity involved in the recognition or measurement of items listed below, it is possible that the outcome in the next financial year could differ from those on which management's estimates are based, resulting in materially different conclusions from those reached by management for purposes of the financial statements. Management's selection of the Bank's accounting policies which contain critical estimates and judgments is listed below; it reflects the materiality of the items to which the policies are applied and the high degree of judgment and estimation uncertainty involved:

(a) Credit and impairment losses (Note 14)

<u>Estimates and judgments applicable to period beginning January 1, 2018 (PFRS 9)</u>

Management believes that the Bank's critical accounting estimates and judgments are those which relate to impairment of financial assets measured at amortised cost and FVOCI. The implementation of PFRS 9 resulted in a change to the assessment of the critical accounting estimates and judgments related to impairment assessment.

The most significant judgments relate to defining what is considered to be a significant increase in credit risk, and in making assumptions and estimates to incorporate relevant information about past events, current conditions and forecasts of economic conditions. A high degree of uncertainty is involved in making estimations using assumptions that are highly subjective and very sensitive to the risk factors.

In determining allowance for credit and impairment losses, management is required to exercise judgment in defining what is considered to be a significant increase in credit risk and in making assumptions and estimates to incorporate relevant information about past events, current conditions and forecasts of economic conditions.

The probability of default (PD), loss given default (LGD) and exposure at default (EAD) models which support these determinations are reviewed regularly in light of differences between loss estimates and actual loss experience, but given that PFRS 9 requirements have only just been applied, there has been little time available to make these comparisons. Therefore, the underlying models and their calibration, including how they react to forward-looking economic conditions, remain subject to review and refinement. This is particularly relevant for lifetime PDs, which have not been previously used in regulatory modelling and for the incorporation of 'Upside scenarios' which have not generally been subject to experience gained through stress testing.

The exercise of judgment in making estimations requires the use of assumptions which are highly subjective and very sensitive to the risk factors, in particular to changes in economic and credit conditions across a large number of geographical areas. Many of the factors have a high degree of interdependency and there is no single factor to which allowance for credit and impairment losses as a whole are sensitive. The adjustment from the allowance for credit and impairment losses determined by using the Central scenario alone, which is used to calculate an unbiased expected loss (EL), provides an indication of the overall sensitivity of ECL to different economic assumptions.

Sensitivity analysis

The effect of sensitivities surrounding forward-looking assumptions are disclosed in Note 6.1.1. The carrying values of loans and receivables and the related allowance for credit and impairment losses of the Bank are disclosed in Notes 11 and 14.

Estimates and judgments applicable to periods prior from January 1, 2018 (PAS 39)

Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the reporting date.

Collective impairment allowances are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis due to the large number of individually insignificant loans in the portfolio. The estimation methods include the use of statistical analyses of historical information, supplemented with significant management judgment, to assess whether current economic and credit conditions are such that the actual level of incurred losses is likely to be greater or less than historical experience. Where changes in economic, regulatory or behavioural conditions result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models, risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

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

For individually assessed loans, judgment is required in determining whether there is objective evidence that a loss event has occurred and, if so, the measurement of the impairment allowance. These include the consideration of whether payments are contractually past-due and the consideration of other factors indicating deterioration in the financial condition and outlook of borrowers affecting their ability to pay. For those loans where objective evidence of impairment exists, management determines the size of the allowance required based on a range of factors such as the realisable value of security, the likely dividend available on liquidation or bankruptcy, the viability of the customer's business model and the capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations. The Bank might provide loan forbearance to borrowers experiencing financial difficulties by agreeing to modify the contractual payment terms of loans in order to improve the management of customer relationships, maximise collection opportunities or avoid default or repossession.

The carrying values of loans and receivables and the related allowance for credit and impairment losses of the Bank are disclosed in Notes 11 and 14.

(b) Realisation of deferred tax assets (Note 23)

Management reviews at each reporting date the carrying amounts of deferred tax assets. The carrying amount of deferred tax assets is reduced to the extent that the related tax assets cannot be utilised due to insufficient taxable profit against which the deferred tax losses will be applied. Management believes that sufficient taxable profit will be generated to allow all or part of the deferred income tax assets to be utilised.

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

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 judgmental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit or greater than 5% of the instrument's valuation is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. 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).

(d) Impairment of AFS financial assets

Estimates and judgments applicable to periods prior from January 1, 2018 (PAS 39)

The Bank follows the guidance of PAS 39 to determine when an AFS financial asset is impaired. This determination requires significant judgment. In making this judgment, the Bank evaluates, among other factors, the duration and extent to which the fair value of an investment is less than its cost; and the financial health and near-term business outlook of the issuer, including factors such as industry and sector performance, changes in technology and operational and financing cash flows.

(e) Provisions

Judgment, and professional expert advice, is involved in determining whether a present obligation exists and in estimating the probability, timing and amount of any outflow.

5 Summary of significant accounting policies

The principal accounting policies applied in the preparation of these financial statements are set out below. These policies have been consistently applied to both years presented, unless otherwise stated.

5.1 Foreign currency translation

Items in the financial statements are measured using the currency of the primary economic environment in which the entity operates (the "functional currency").

Transactions in foreign currencies are initially recorded at the functional rate of exchange at the date of transaction.

Foreign currency-denominated monetary assets and liabilities in the RBU and FCDU of the Bank are translated to their respective functional currencies based on the closing rate prevailing as at the reporting date and weighted average rate for the reporting period for income and expenses. Foreign exchange differences arising from foreign currency transactions and restatements of foreign currency-denominated assets and liabilities are credited to or charged against the statement of income in the period in which the rates change.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

As at the reporting date, the assets and liabilities of the FCDU of the Bank is translated from its functional currency to the presentation currency, the PHP, at the closing rate prevailing at the reporting date, and their income and expenses are translated at weighted average rate for the year. Exchange differences arising from translation of the FCDU balances to the presentation currency of the Bank are taken directly to the statement of total comprehensive income. Upon remittance of the FCDU's net income to the RBU, the deferred cumulative amount recognised in the statement of total comprehensive income is recognised under the "Foreign exchange profit, net" in the statement of income.

5.2 Financial instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. The Bank recognises a financial instrument in the statement of financial position when, and only when, the Bank becomes a party to the contractual provisions of the instrument.

Policies applicable beginning January 1, 2018 (PFRS 9)

(a) Financial assets

5.2.1 Classification and subsequent measurement

The classification requirements for financial instruments are described below:

(i) 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 cash and other cash items, due from Bangko Sentral ng Pilipinas, due from other banks, interbank loans receivables and securities purchased under resale agreements, and loans and receivables. In addition, most financial liabilities are measured at amortised cost. The Bank 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, the difference is deferred and recognised over the life of the loan through the recognition of interest income.

The Bank 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 Bank intends to hold the loan, the loan commitment is included in the impairment calculations set out below.

When debt securities are sold subject to a commitment to repurchase them at a predetermined price ('repurchase agreement'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to resell ('reverse repurchase agreement') are not recognised on the balance sheet and an asset is recorded in respect of the initial consideration paid.

Non-trading repurchase agreements and reverse repurchase agreements 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.

Contracts that are economically equivalent to repurchase agreements or reverse repurchase 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, repurchase agreements or reverse repurchase agreements.

(ii) Fair value through other comprehensive income (FVOCI)

Debt securities

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 FVOCI. These primarily comprise debt securities at FVOCI. They are recognised on the trade date when the Bank 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 statement of income as 'Trading gains (losses), net'. Financial assets measured at FVOCI are included in the impairment calculations set out below and impairment is recognised in profit or loss.

Equity securities

The equity securities for which fair value movements are shown in other comprehensive income are investments where the Bank holds the financial assets other than to generate a capital return. Gains or losses on the derecognition of these equity securities are not transferred to profit or loss. Otherwise, equity securities are measured at fair value through profit or loss (except for dividend income which is recognised in profit or loss).

(iii) Financial instruments designated at fair value through profit or loss

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below and are so designated irrevocably at inception:

- the use of the designation removes or significantly reduces an accounting mismatch;
- a group of financial assets and liabilities or a group of financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy; and
- the financial liability contains one or more non-closely related embedded derivatives.

Designated financial assets are recognised when the Bank enters into contracts with counterparties, which is generally on trade date, and are normally derecognised when the rights to the cash flows expire or are transferred. Designated financial liabilities are recognised when the Bank enters into contracts with counterparties, which is generally on settlement date, and are normally derecognised when extinguished. Subsequent changes in fair values are recognised in the statement of income as 'Trading gains (losses), net'.

(iv) 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 recognised initially and are subsequently measured at fair value, with changes in fair value generally recorded in the statement of income. Derivatives are classified as assets when their fair value is positive or as liabilities when their fair value is negative. This includes embedded derivatives in financial liabilities which are bifurcated from the host contract when they meet the definition of a derivative on a stand-alone basis.

Where the derivatives are managed with debt securities issued by the group that are designated at fair value, the contractual interest is shown in 'Interest expense' together with the interest payable on the issued debt.

Hedge accounting

When derivatives are held for risk management purposes, they are designated in hedge accounting relationships where the required criteria for documentation and hedge effectiveness are met. The Bank enters into fair value hedges, cash flow hedges or hedges of net investments in foreign operations as appropriate to the risk being hedged.

Fair value hedge

Fair value hedge accounting does not change the recording of gains and losses on derivatives and other hedging instruments, but results in recognising changes in the fair value of the hedged assets or liabilities attributable to the hedged risk that would not otherwise be recognised in the statement of income. If a hedge relationship no longer meets the criteria for hedge accounting, hedge accounting is discontinued; the cumulative adjustment to the carrying amount of the hedged item is amortised to the statement of income on a recalculated effective interest rate, unless the hedged item has been derecognised, in which case it is recognised in the statement of income immediately.

Cash flow hedge

The effective portion of gains and losses on hedging instruments is recognised in other comprehensive income; the ineffective portion of the change in fair value of derivative hedging instruments that are part of a cash flow hedge relationship is recognised immediately in the statement of income within 'Trading gains (losses), net'. The accumulated gains and losses recognised in other comprehensive income are reclassified to the statement of income in the same periods in which the hedged item affects profit or loss. In hedges of forecast transactions that result in recognition of a non-financial asset or liability, previous gains and losses recognised in other comprehensive income are included in the initial measurement of the asset or liability. When a hedge relationship is discontinued, or partially discontinued, any cumulative gain or loss recognised in other comprehensive income remains in equity until the forecast transaction is recognised in the statement of income. When a forecast transaction is no longer expected to occur, the cumulative gain or loss previously recognised in other comprehensive income is immediately reclassified to the statement of income.

Derivatives that do not qualify for hedge accounting

Non-qualifying hedges are derivatives entered into as economic hedges of assets and liabilities for which hedge accounting was not applied.

5.2.2 Impairment

Expected credit losses ('ECL') are recognised for cash and other cash items, due from Bangko Sentral ng Pilipinas, due from other banks, interbank loans receivables and securities purchased under resale agreements, financial assets at FVOCI, loans and receivables, and certain loan commitments and financial guarantee contracts.

At initial recognition, allowance for credit and impairment losses 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, as set out below.

If a financial instrument that includes both a loan and an undrawn loan commitment component and the Bank cannot separately identify the ECL on these loan commitment, the ECL is recognised together with the allowance for credit and impairment losses for the financial asset. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be recognised as a provision.

Details of impairment methodology is disclosed in succeeding section.

(a) Determination of default and credit-impaired

The Bank 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.

(b) Determination of significant increase in credit risk

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. 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.

Retail loan portfolios

Default risk is assessed using a reporting date 12-month PD. This PD is adjusted for the effect of macroeconomic forecasts for periods longer than 12 months and is considered to be a reasonable approximation of a lifetime PD measure. Retail exposures are first segmented into homogeneous portfolios, generally by product, age and score. Within each portfolio, the stage 2 accounts are defined as accounts with an adjusted 12-month PD greater than the average 12-month PD of loans in that portfolio 12 months before they become 30 days past due. The expert credit risk judgment is that no prior increase in credit risk is significant. This portfolio-specific threshold identifies loans with a PD higher than would be expected from loans that are performing as originally expected, and higher than what would have been acceptable at origination. It therefore approximates a comparison of origination to reporting date PDs.

Investments in debt securities

Debt securities, including cash and other cash items, due from Bangko Sentral ng Pilipinas, due from other banks, interbank loans receivables and securities purchased under agreement to resell, and financial assets at FVOCI, where external market ratings are available and credit ratings are not used in credit risk management, the debt securities will be in stage 2 if their credit risk increases to the extent they are no longer considered investment grade. Investment grade is where the financial instrument has a low risk of incurring losses, the structure has a strong capacity to meet its contractual cash flow obligations in the near term, and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil their contractual cash flow obligations.

(c) 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.

(d) Purchased or originated credit impaired

Financial assets that are purchased or originated at a deep discount that reflects the incurred credit losses are considered to be POCI. This population includes the recognition of a new financial instrument following a renegotiation where concessions have been granted for economic or contractual reasons relating to the borrower's financial difficulty that otherwise would not have been considered. The amount of change-in-lifetime ECL is recognised in profit or loss until the POCI is derecognised, even if the lifetime ECL are less than the amount of ECL included in the estimated cash flows on initial recognition

(e) Movement between stages

Financial assets can be transferred between the different categories (other than POCI) depending on their relative increase in credit risk since initial recognition. Financial instruments are transferred out of stage 2 if their credit risk is no longer considered to be significantly increased since initial recognition based on the assessments described above. Except for renegotiated loans, financial instruments are transferred out of stage 3 when they no longer exhibit any evidence of credit impairment as described above. Renegotiated loans that are not POCI will continue to be in stage 3 until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, observed over a minimum one-year period and there are no other indicators of impairment. For loans that are assessed for impairment on a portfolio basis, the evidence typically comprises a history of payment performance against the original or revised terms, as appropriate to the circumstances. For loans that are assessed for impairment on an individual basis, all available evidence is assessed on a case-by-case basis.

(f) Measuring ECL - Explanation of inputs, assumptions and estimation techniques

The assessment of credit risk and the estimation of ECL are unbiased and probability-weighted, and incorporate all available information that 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, the Bank calculates ECL using three main components: PD, LGD and EAD.

The Bank leverages on the existing framework available, with recalibration to meet the differing PFRS 9 requirements as set out in the following table:

	Significance trigger- PD to increase by:
PD	• Point in time (based on current conditions, adjusted to take into account estimates of future conditions that will impact PD) • Default backstop of 90+ days past due for all portfolios
EAD	• Amortisation captured for term products • Consideration of undrawn balance of revolving facilities
LGD	• Expected LGD (based on estimate of loss given default including the expected impact of future economic conditions such as changes in value of collateral) • Discounted using the original effective interest rate of the loan • Only costs associated with obtaining/selling collateral included

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. The lifetime PDs are determined by projecting the 12-month PD using a term structure.

The EAD represents the expected balance at default, taking into account the repayment of principal and interest from the balance sheet date to the default event together with any expected drawdowns of committed facilities.

The LGD represents expected losses on the EAD given the event of default, taking into account, among other attributes, the mitigating effect of collateral value at the time it is expected to be realised and the time value of money.

Retail loan portfolios are collectively assessed and grouped on the basis of similar risk characteristics, taking into account either the loan type, past due status, and behaviour score. The collectively-assessed allowance for impairment reflects: (i) the expected amount of principal and interest calculated under the terms of the original loan agreement that will not be recovered, and (ii) the impact of time delays in collecting principal and/or interest (time value of money).

The expected principal and interest collection is estimated on a portfolio basis and references historical loss experience of comparable portfolios with similar credit risk characteristics, adjusted for the current environment and expected future conditions. A portfolio specific coverage ratio is applied against the impaired loan balance in determining the collectively assessed allowance for impairment. The time value of money component is calculated by the discount factors applied to groups of loans sharing common characteristics. The discount factors represent the expected recovery pattern of the comparable group of loans, and reflect the historical experience of these groups adjusted for current expected future economic conditions and/or industry factors. Significant judgment is required in assessing evidence of impairment and estimation of the amount and timing of future cash flows when determining expected credit losses. Changes in the amount expected to be recovered would have a direct impact on impairment losses and may result in a change in allowance for impairment.

Period over which ECL is measured

Expected credit loss is measured from the initial recognition of the financial asset. The maximum period considered when measuring ECL (be it 12-month or lifetime ECL) is the maximum contractual period over which the Bank is exposed to credit risk.

(g) Forward-looking information incorporated in the ECL models

The Bank generally applies three forward-looking global economic scenarios determined with reference to external forecast distributions representative of our view of forecast economic conditions, the consensus economic scenario approach. This approach is considered sufficient to calculate unbiased expected loss in most economic environments. They represent a most likely outcome (the Central scenario) and two, less likely, outer scenarios referred to as the Upside and Downside scenarios. The Central scenario is the basis for the annual operating planning process and, with regulatory modifications, will also be used in enterprise-wide stress tests. The Upside and Downside scenarios are constructed following a standard process supported by a scenario narrative reflecting the Bank's current top and emerging risks and by consulting external and internal subject matter experts.

The relationship between the outer scenarios and Central scenario will generally be fixed with the Central scenario being assigned a weighting of 80% and the Upside and Downside Concentration of exposure scenarios 10% each, with the difference between the Central and outer scenarios in terms of economic severity being informed by the spread of external forecast distributions among professional industry forecasts. The outer scenarios are economically plausible, internally consistent states of the world and will not necessarily be as severe as scenarios used in stress testing. The period of forecasts is five years for the Central scenario. Upside and Downside scenarios use distributional forecasts for the first two years, after which they converge to the Central forecasts. The spread between the Central and outer scenarios is grounded on consensus distributions of projected gross domestic product of the economy. The economic factors include, but are not limited to, gross domestic product, unemployment, interest rates, inflation and commercial property prices across all the countries and territories in which the Bank operates.

In general, the consequences of the assessment of credit risk and the resulting ECL outputs will be probability-weighted using the standard probability weights. This probability weighting may be applied directly or the effect of the probability weighting determined on a periodic basis, at least annually, and then applied as an adjustment to the outcomes resulting from the central economic forecast. The central economic forecast is updated quarterly.

5.2.3 Write-off

Financial assets (and the related allowance for credit and impairment losses) 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.

The Bank may write-off financial assets that are still subject to enforcement activity. The outstanding contractual amounts of such assets written off during the year ended December 31, 2018 was P5.76 million. The write-off of loans is being approved by the BOD in compliance with the BSP requirements.

5.2.4 Renegotiation

Loans are identified as renegotiated and classified as credit impaired when the Bank modifies the contractual payment terms due to significant credit distress of the borrower. Non-payment-related concessions (e.g. covenant waivers), while potential indicators of impairment, do not trigger identification as renegotiated loans. 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 derecognition.

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 derecognition 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.

Personal renegotiated loans are deemed to be credit-impaired until repayment or derecognition.

5.2.5 Loan modification that are not credit impaired

Loan modifications that are not identified as renegotiated are considered to be commercial restructuring. Where a commercial restructuring results in a modification (whether legalised through an amendment to the existing terms or the issuance of a new loan contract) such that the Bank's rights to the cash flows under the original contract have expired, the old loan is derecognised and the new loan is recognised at fair value. The rights to cash flows are generally considered to have expired if the commercial restructure is at market rates and no payment-related concession has been provided.

(b) Financial liabilities

Refer to the discussion of accounting policies for financial instruments under Notes 5.2.6, 5.2.7 and 5.2.9 for the initial recognition, subsequent measurement, classification and derecognition of financial liabilities. The policies on financial liabilities did not change when the Bank adopted PFRS 9.

Policies applicable prior to January 1, 2018 (PAS 39)

5.2.6 Date of recognition

Purchases or sales of financial assets and liabilities at FVTPL and AFS financial assets, which require delivery of assets within the time frame established by regulation or convention in the market place, are recognised on the trade date - the date when the Bank commits to purchase or sell the assets. Deposits, amounts due to banks and customers, due from BSP and other banks and loans and receivables are recognised when cash is received by the Bank or advanced to the borrowers.

Initial recognition of financial instruments

All financial instruments are initially recognised at fair value. Except for financial instruments at FVTPL, the initial measurement includes transaction costs. The Bank classifies their financial assets in the following categories: financial assets at FVTPL, AFS financial assets, held-to-maturity (HTM) investments and loans and receivables. Financial liabilities are classified into financial liabilities at FVTPL and other financial liabilities. The category depends on the purpose for which the investments were acquired or the liabilities were incurred and whether they are quoted in an active market, and for HTM investments, the ability and intention to hold the investment until maturity. Management determines the category of its financial instruments at initial recognition and, where allowed and appropriate, re-evaluates such designation at every reporting date. As at December 31, 2017, the Bank has no outstanding HTM investments.

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 recognised 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. This includes embedded derivatives in financial liabilities, which are bifurcated from the host contract when they meet the definition of a derivative on a stand-alone basis. Where the derivatives are managed with debt securities issued by the Bank that are designated at fair value, the contractual interest is shown in 'Interest expense' together with the interest payable on the issued debt.

5.2.7 Classification and measurement

The classification requirements for financial instruments are described below:

Financial assets or financial liabilities at FVTPL

This category includes financial instruments that are held-for-trading, those that are designated as at FVTPL financial assets or liabilities, and derivatives recorded at FVTPL.

(a) Financial assets held-for-trading

Financial assets held-for-trading are recorded in the statement of financial position at fair value. Changes in fair value relating to the held-for-trading positions are recognised under "Trading gains (losses), net" in the statement of income. Interest earned or incurred is recorded as interest income in the statement of income.

(b) Financial instruments designated at FVTPL

Financial assets and liabilities classified in this category are designated by management on initial recognition. Management may only designate an instrument at FVTPL upon initial recognition when the following criteria are met, and designation is determined on an instrument-by-instrument basis:

- The designation eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets or liabilities or recognising gains or losses on them on a different basis; or

- The assets and liabilities are part of a group of financial assets, financial liabilities or both which are managed and their performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy; or

- The financial instrument contains an embedded derivative, unless the embedded derivative does not significantly modify the cash flows or it is clear, with little or no analysis, that it would not be separately recorded.

Financial instruments designated at FVTPL are initially recognised in the statement of financial position at fair value. Changes in fair value on financial instruments designated at FVTPL are recorded in "Trading gains (losses), net" in the statement of income. Interest earned or incurred is recognised as "Interest income" or "Interest expense," respectively, in the statement of income.

(c) Derivatives recorded at FVTPL

The Bank is a counterparty to derivative contracts, such as interest rate swap agreement and foreign exchange contracts to reduce and manage its foreign exchange and interest rate exposures. Such derivative financial instrument is initially recorded at fair value on the date when the derivative contract is entered into and is subsequently remeasured at fair value. Any gain or loss arising from changes in fair values of derivatives (except those accounted for as accounting hedges) are taken directly to "Trading gains (losses), net" in the statement of income. Derivatives are carried as assets when the fair value is positive and liabilities when the fair value is negative.

The method of recognising fair value gains and losses depends on whether the derivatives are held-for-trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. When derivatives are designated as hedges, the Bank classifies them as either: (a) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (b) hedges of the variability in highly probable future cash flow attributable to a recognised asset or liability or a forecast transaction ('cash flow hedges'); or (c) hedges of net investment in a foreign operation ('net investment hedges'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

There were no transactions designated as fair value hedge in 2018 and 2017.

Hedge accounting

At the inception of a hedging relationship, the Bank documents the relationship between the hedging instruments and the hedged items, including the nature of the risk, its risk management objective and its strategy for undertaking the hedge, and the method that will be used to assess the effectiveness of the hedging relationship. The Bank also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments, primarily derivatives, that are used in hedging transactions are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items. Interest on designated qualifying hedges is included in “Interest income - Trading and investment securities” in the statement of income.

Fair value changes of the derivatives designated as hedging instruments, which are immediately reported in the statement of income, are included in “Trading gains (losses), net”.

Fair value hedge

Changes in the fair value of derivatives that qualified and are designated as fair value hedging instruments are immediately recorded in the statement of income under “Trading gains (losses), net”, along with changes in the fair value of the hedged assets, liabilities or group thereof that are attributable to the hedged risk.

The hedge relationship is terminated under the following circumstances: if the hedging instrument has expired or is sold, terminated or exercised or if the hedge no longer meets the criteria for hedge accounting. The cumulative adjustment to the carrying amount of the hedged item for which the effective interest method is used is amortised based on a recalculated effective interest rate (EIR) over the residual period to maturity and recognised in the statement of income, unless the hedged item has been derecognised, in which case, it is immediately released to the statement of income.

However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortisation using a recalculated EIR is not practicable, the adjustment shall be amortised using the straight-line method. The adjustment shall be amortised fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.

Hedge effectiveness testing

To qualify for hedge accounting, the Bank requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness) and demonstrate actual effectiveness (retrospective effectiveness) on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method that the Bank adopts for assessing hedge effectiveness will depend on its risk management strategy.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness to be achieved, the changes in fair value or cash flows must offset each other with a slope coefficient within the range of -0.80 and -1.25 and an R-square greater than 0.80. However, hedges with a slope coefficient falling outside the -0.90 to -1.10 range but within the -0.80 and -1.25 range would be considered “At risk”.

Embedded derivatives

Embedded derivatives are bifurcated from their host contracts and carried at fair value with fair value changes being reported in the statement of income, when the entire hybrid contract (composed of both the host contract and the embedded derivative) is not accounted for as financial assets at FVTPL, and when their economic risks and characteristics are not closely related to those of their respective host contracts.

In 2017, the Bank does not have any embedded derivatives which were bifurcated.

(d) AFS financial assets

AFS financial assets are those which are designated as such or do not qualify to be classified as financial assets at FVTPL, HTM investments or loans and receivables. They are purchased and held indefinitely, and may be sold in response to liquidity requirements or changes in market conditions. They include equity investments, money market papers and other debt instruments.

After initial measurement, AFS financial assets are subsequently measured at fair value. The effective yield component of AFS debt securities, as well as the impact of restatement on foreign currency-denominated AFS debt securities in RBU books, is reported under “Interest income - Investment securities” and “Foreign exchange profit, net” in the statement of income, respectively. The unrealised gains and losses arising from the fair valuation of AFS financial assets are excluded net of tax from reported income and are reported as “Net unrealised gains (losses) on AFS financial assets” in the statement of comprehensive income to the extent they are not hedged.

When the AFS financial assets are sold, the cumulative gains or losses previously recognised in the statement of total comprehensive income is recognised as part of “Trading gains (losses), net” in the statement of income. Where the Bank holds more than one investment in the same security, these are deemed to be disposed of on a weighted average cost basis. Interest earned on holding AFS debt investments are reported as “Interest income - Investment securities” in the statement of income using the effective interest method. Dividends earned on holding AFS equity investments are recognised in the statement of income under “Other operating income” when the right of payment has been established. This is the ex-dividend date for listed equity securities and the date of shareholders’ approval for non-listed equity securities. The losses arising from impairment of such investments are recognised as “Credit and impairment losses” in the statement of income.

(e) Loans and receivables

The Bank’s loans and receivables include “Due from BSP”, “Due from other banks”, “Interbank loans receivable and securities purchased under resale agreements (SPURA)”, “Loans and receivables”, returned checks and other cash items (RCOCI) and refundable deposits under “Other assets”. These are financial assets with fixed or determinable payments and fixed maturities that are not quoted in an active market. They are not entered into with the intention of immediate or short-term resale and are not classified as financial assets at FVTPL or designated as AFS financial assets.

After initial measurement, loans and receivables are subsequently measured at amortised cost using the effective interest method, less allowance for credit and impairment losses, if any.

Amortised cost is calculated by taking into account any discount or premium on acquisition and fees that are an integral part of the EIR. The amortisation is included in “Interest income - Loans and receivables” in the statement of income. The losses arising from impairment are recognised in “Credit and impairment losses” in the statement of income.

(f) Repurchase and reverse repurchase agreements

Securities purchased under agreements to resell at a specified future date ('reverse repurchase agreements') are not recognised in the statement of financial position. The corresponding cash paid including accrued interest, is recognised in the statement of financial position as SPURA under "Interbank loans receivables and SPURA" and is considered a loan to the counterparty with the securities considered as collateral. The difference between the purchase price and resale price is treated as interest income and is accrued over the life of the agreement using the EIR method.

Conversely, securities sold under agreements to repurchase at a specified future date ('repurchase agreements') are not derecognised from the statement of financial position. The corresponding cash received, including accrued interest, is recognised in the statement of financial position as "Bills payable" and is considered as a loan to the Bank with the securities treated as collateral, reflecting the economic substance of such transaction.

(g) Financial liabilities

The Bank's other financial liabilities include "Deposit liabilities", "Bills payable", "Cashier's orders", and accrued expenses, unclaimed balances, accounts payable and accrued interest payable under "Accrued expenses and other liabilities".

Issued financial instruments or their components, which are not designated as financial liabilities at FVTPL, are classified as liabilities under "Deposit liabilities", "Bills payable", "Cashier's orders" or other appropriate financial liability accounts, where the substance of the contractual arrangement results in the Bank having an obligation either to deliver cash or another financial asset to the holder, or to satisfy the obligation other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of own equity shares. The components of issued financial instruments that contain both liability and equity elements are accounted for separately, with the equity component being assigned the residual amount after deducting from the instrument as a whole the amount separately determined as the fair value of the liability component on the date of issue.

After initial measurement, other financial liabilities are subsequently measured at amortised cost using the effective interest method. Amortised cost is calculated by taking into account any discount or premium on the issue and fees that are an integral part of the effective interest method. The amortisation is included as "Interest expense" in the statement of income.

5.2.8 Impairment

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

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

(a) AFS financial assets

For AFS financial assets, the Bank assesses at each reporting date whether there is objective evidence that a financial asset or a group of financial assets is impaired.

In case of equity investments classified as AFS financial assets, objective evidence would include a significant or prolonged decline in the fair value of the investments below their cost. The determination of what is significant and prolonged is subject to judgment. When there is evidence of impairment, the cumulative loss, which is measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in the statement of income, is removed from equity and is recognised in the statement of income. Impairment losses on equity investments are not reversed through the statement of income. Increases in fair value after impairment are recognised directly in the statement of comprehensive income.

In the case of debt instruments classified as AFS financial assets, impairment is assessed based on the same criteria as financial assets carried at amortised cost. Future interest income is based on the reduced carrying amount and is accrued based on the rate of interest used to discount future cash flows for the purpose of measuring impairment loss. Such accrual is recorded as part of "Interest income - Trading and investment securities" in the statement of income. If, in the subsequent year, the fair value of a debt instrument increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in the statement of income, the impairment loss is reversed through the statement of income.

(b) Financial assets carried at amortised cost

For financial assets carried at amortised cost, the Bank first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, or collectively for financial assets that are not individually significant. For individually assessed financial assets, the amount of loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows (excluding future credit losses that have not been incurred). The present value of the estimated future cash flows is discounted at the financial asset's original EIR.

If a financial asset has a variable interest rate, the discount rate for measuring any impairment loss is the current EIR, adjusted for the original credit risk premium.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

Financial assets that are individually assessed for impairment and for which an impairment loss is, or continues to be, recognised are not included in a collective assessment for impairment. The carrying amount of the asset is reduced through use of an allowance account and the amount of loss is charged to "Credit and impairment losses" in the statement of income. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognised, the previously recognised impairment loss is increased or reduced by adjusting the allowance account. HTM investments and loans and receivables, together with the associated allowance accounts, are written off when there is no realistic prospect of future recovery and all collateral has been realised. If a future write-off is later recovered, any amounts formerly charged are credited to the "Other operating income" in the statement of income. Interest income continues to be recognised based on the original EIR of the financial asset.

If the Bank determines that no objective evidence of impairment exists for individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of such similar credit risk characteristics as industry, collateral type, past due status and term. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group.

Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect, and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status, or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to reduce any difference between loss estimates and actual loss experience.

(c) Restructured loans

Where possible, the Bank seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. The loan is no longer considered past due upon renegotiation of terms, and fulfillment of defined qualifying criteria. Management continuously reviews restructured loans to ensure that all criteria are met and that future payments are likely to occur. The loans continue to be subject to an individual or collective impairment assessment, calculated using the loan's original EIR. The difference between the recorded value of the original loan and the present value of the restructured cash flows, discounted at the original EIR, is recognised in "Credit and impairment losses" in the statement of income.

If a renegotiation or modification of terms of an existing loan agreement is such that the cash flows of the modified loan agreement are substantially different from those of the original loan agreement, then the original loan agreement is derecognised and the modified financial asset is recognised as a new loan agreement and initially measured at fair value.

5.2.9 Derecognition

(a) 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 asset have expired;
- the Bank retains the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a "pass-through" arrangement; or
- the Bank has transferred its rights to receive cash flows from the asset and either (a) has transferred substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially the risks and rewards of the asset but has transferred control of the asset.

When the Bank has transferred its rights to receive cash flows from an asset or has entered into a pass-through arrangement, and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control over the asset, the asset is recognised to the extent of the Bank's continuing involvement in the asset. Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Bank could be required to repay.

(b) Financial liabilities

A financial liability is derecognised when the obligation under the liability is discharged, cancelled or has expired. When 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 and the difference in the respective carrying amounts is recognised in the statement of income.

<u>Policies under both PFRS 9 and PAS 39</u>

5.2.10 Fair value measurement

'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 in the principal market or, in its absence, the most advantageous market to which the Bank has access at that date. The fair value of a liability reflects its non-performance risk.

When available, the Bank measures the fair value of an instrument using the quoted price in an active market for that instrument. A market is regarded as active if transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

If there is no quoted price in an active market, then the Bank uses valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The chosen valuation technique incorporates all of the factors that market participants would take into account in pricing a transaction.

5.2.11 'Day 1' difference

Where the transaction price in a non-active market is different from the fair value of other observable current market transactions in the same instrument or based on a valuation technique whose variables include only data from observable market, the Bank recognises the difference between the transaction price and the fair value (a 'Day 1' difference) in the statement of income. In cases where non-market observable data is used, the difference between the transaction price and the model value is only recognised in the statement of income when the inputs become observable or when the instrument is derecognised. For each transaction, the Bank determines an appropriate method of recognising 'Day 1' difference amount. Subsequently, that difference is recognised in the statement of income on an appropriate basis over the life of the instrument but no later than when the valuation is wholly supported by observable market data or the transaction is closed out.

Portfolios of financial assets and financial liabilities that are exposed to market risk and credit risk that are managed by the Bank on the basis of the net exposure to either market or credit risk are measured on the basis of a price that would be received to sell a net long position (or paid to transfer a net short position) for a particular risk exposure. Those portfolio-level adjustments are allocated to the individual assets and liabilities on the basis of the relative risk adjustment of each of the individual instruments in the portfolio.

The fair value of financial instruments is generally measured on an individual basis. However, in cases where a group of financial assets and liabilities is managed 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 PFRSs offsetting criteria.

5.2.12 Offsetting of financial instruments

Financial assets and financial liabilities are offset and the net amount reported in the statement of financial position if, and only if, there is a currently enforceable legal right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and to settle the liability simultaneously ('the offset criteria').

Currently having a legally enforceable right of set-off means that in order to meet the offsetting criteria, the Bank must currently have the enforceable legal right that is not contingent on a future event; and must be legally enforceable in all circumstances, including the normal course of business, as well as in the event of default, insolvency or bankruptcy of the Bank and all counterparties to the contracts.

The availability of a right of set-off cannot be contingent or conditional on a future event. The passage of time or uncertainties in amounts to be paid are not considered to be contingencies. However, if the right of set-off is not exercisable during a period when amounts are due and payable, then the Bank does not meet the requirement as it has no right to set-off those payments. Similarly, a right of set-off that could disappear or is no longer enforceable on the occurrence of a future event would not meet this requirement.

This is not generally the case with master netting agreements, as the related assets and liabilities are presented gross in the statement of financial position.

5.3 Cash and cash equivalents

For purposes of reporting cash flows, cash and cash equivalents include "Cash and other cash items", "Due from BSP", "Due from other banks" and "Interbank loans receivable and SPURA" which are convertible to known amounts of cash with original maturities of three months or less from dates of placements and which are subject to insignificant risk of changes in value.

5.4 Property and equipment

The initial cost of property and equipment consists of its purchase price, including import duties, taxes, and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Such cost includes the cost of replacing part of the equipment when the cost is incurred and if the recognition criteria are met, but excludes repairs and maintenance cost. In situations where it can be clearly demonstrated that the expenditures have resulted in an increase in the future economic benefits expected to be obtained from the use of an item of property and equipment beyond its originally assessed standard of performance, the expenditures are capitalised as an additional cost of property and equipment.

Depreciation and amortisation is calculated using the straight-line method over the estimated useful life of the depreciable assets. Leasehold improvements are amortised over the shorter of the term of the covering leases and the estimated useful lives of the improvements.

The range of estimated useful lives of the depreciable assets follows:

	Number of Years
Furniture, fixtures and equipment	2 - 7
Leasehold improvements	3 - 5

The depreciation and amortisation method, residual value and useful lives are reviewed periodically to ensure that the method and period of depreciation and amortisation are consistent with the expected pattern of the economic benefits for items of property and equipment.

An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use.

An item of property and equipment is derecognised upon disposal or when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included under “Other operating income - net” in the statement of income in the period the item is derecognised.

5.5 Assets held-for-sale

Non-current assets are classified as held for sale when their carrying amounts will be recovered principally through sale rather than through continuing use. Held for sale assets are generally measured at the lower of their carrying amount and fair value less cost to sell. Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in ‘Other assets’ at the carrying amounts of the assets classified as held for sale. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale.

5.6 Impairment of non-financial assets

Property and equipment and Assets held-for-sale

At each reporting date, the Bank assesses whether there is any indication that its property and equipment and assets held-for-sale may be impaired or whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. When an indicator of impairment exists or when an annual impairment testing for “Property and equipment” and “Assets held-for-sale” is required, the Bank makes a formal estimate of the recoverable amount.

Recoverable amount is the higher of a non-financial asset’s fair value less costs to sell and its value in use and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets, in which case the recoverable amount is assessed as part of the cash generating unit to which it belongs. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss is charged to profit or loss in the year in which it arises. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset’s recoverable amount since the last impairment loss was recognised. If that is the case, the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation and amortisation, had no impairment loss been recognised for the asset in prior years. Such reversal is recognised in the statement of income.

After such a reversal, any depreciation and amortisation expense is adjusted in future years to allocate the asset’s revised carrying amount, less any residual value, on a systematic basis over its remaining life.

5.7 Revenue recognition

Revenue is recognised to the extent that it is probable that economic benefits will flow to the Bank and the revenue can be reliably measured.

Determining whether the Bank is acting as principal or agent

The Bank assesses its revenue arrangements against the following criteria to determine whether it is acting as a principal or an agent:

- whether the Bank has primary responsibility for providing the services;
- whether the Bank has discretion in establishing prices; and
- whether the Bank bears the credit risk.

The Bank has determined that they are acting as principal in their revenue arrangements except for fiduciary activities where the Bank acts in a fiduciary capacity such as nominee, trustee or agent. The Bank recognises income from fiduciary activities under “Fees and commission income” in the statement of income.

The following specific recognition criteria must also be met before revenue is recognised:

Policies applicable beginning on January 1, 2018 (PFRS 9 and 15)

Non-interest income

Fee income is generated from services provided at a fixed price over time, such as account service and card fees, or when a specific transaction is delivered at a point in time such as broking services and import/export services. With the exception of certain fund management and performance fees, all other fees are generated at a fixed price. Variable fees are recognised when all uncertainties are resolved. Fee income is generally earned from short term contracts with payment terms that do not include a significant financing component.

Fee income earned on transaction-based arrangements is recognised at a point in time when the Bank has fully provided the service to the customer. Where the contract requires services to be provided over time, income is recognised on a systematic basis over the life of the agreement.

Net income (expense) from financial instruments measured at fair value through profit or loss includes the following:

- ‘Net income from financial instruments held for trading or managed on a fair value basis’. This element is comprised of the net trading income, which includes all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with the related interest income, expense and dividends; and it also includes all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities measured at fair value through profit or loss.

- ‘Changes in fair value of long-term debt and related derivatives’. Interest paid on the external long-term debt and interest cash flows on related derivatives is presented in interest expense.

- ‘Changes in fair value of other financial instruments mandatorily measured at fair value through profit or loss’. This includes interest on instruments which fail the solely payments of principal and interest test.

Policies applicable prior to January 1, 2018 (PAS 18)

Non-interest income

(a) Fees and commission income is earned from a diverse range of services provided by the Bank to its customers. Fees and commission income is accounted for as follows:

- income earned from the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third-party, such as an arrangement for the acquisition of shares or other securities);

- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and

- income which forms an integral part of the effective interest rate (EIR) of a financial instrument is recognised as an adjustment to the EIR (for example, certain loan commitment fees) and recorded in “Interest income”.

(b) Trading gains (losses), net comprises all gains and losses from changes in fair value of financial assets and financial liabilities at FVTPL and gains and losses from disposal of financial assets at FVTPL and AFS financial assets.

Policies applicable prior to both periods

Interest income and expense

Interest income and expense for all financial instruments, excluding those classified as held for trading or designated at fair value are recognised in ‘Interest income’ and ‘Interest expense’ in the statement of income using the effective interest method. However, as an exception to this, interest on debt securities issued by the Group that are designated under the fair value option and derivatives managed in conjunction with those debt securities are included in interest expense.

Interest on impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Under PFRS 9, financial instruments measured mandatorily at fair value through profit or loss is a residual category. Given its residual nature, the presentation of the statement of income has been updated to separately present coupon interest payments received from financial asset at FVTPL as part of 'Net income (loss) from financial assets at FVPTL'. These interest payments received are of a dissimilar nature or function with interest income calculated using the effective interest method. There is no impact on net income previously reported.

Dividend income

Dividend income is recognised when the right to receive payment is established.

5.8 Expense recognition

Expenses are recognised in the statement of income when a decrease in future economic benefits related to a decrease in an asset or an increase in a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets.

5.9 Offsetting income and expenses

Offsetting of income and expenses is provided in PAS 1 Presentation of Financial Statements while PAS 32 provides guidance for offsetting of financial assets and financial liabilities (ie balance sheet offsetting). As such, the net presentation of income and expenses in profit and loss does not automatically follow the balance sheet presentation of the related assets and liabilities. Instead, the net presentation of income and expenses is assessed in the context of specific facts and circumstances of each fact pattern. In accordance with PAS 1, income and expenses should not be offset unless required or permitted by a Standard or an Interpretation.

5.10 Leases

The determination of whether an arrangement is, or contains a lease, is based on the substance of the arrangement and requires an assessment of whether the fulfilment of the arrangement is dependent on the use of a specific asset or assets and the arrangement conveys a right to use the asset. A reassessment is made after inception of the lease only if one of the following applies:

(a) There is a change in contractual terms, other than a renewal or extension of the arrangement;
(b) A renewal option is exercised or extension granted, unless the term of the renewal or extension was initially included in the lease term;
(c) There is a change in the determination of whether fulfilment is dependent on specified asset; or
(d) There is a substantial change to the asset.

Where a reassessment is made, lease accounting shall commence or cease from the date when the change in circumstances gave rise to the reassessment for scenarios (a), (c) or (d) above, and the date of renewal or extension period for scenario (b).

Bank as Lessee

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognised as an expense under “Occupancy and equipment-related costs” in the statement of income on a straight-line basis over the lease term. When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognised as an expense in the period in which the termination takes place.

5.11 Employee benefits

Retirement benefits

The Bank is covered by a funded defined benefit plan and a defined contribution plan. The defined benefit plan is non-contributory.

The Bank's net obligation in respect of the defined benefit plan is calculated by estimating the amount of the future benefit that employees have earned in the current and prior periods, discounting that amount and deducting the fair value of any plan assets.

The calculation of defined benefit obligation is performed on a periodic basis by a qualified actuary using the projected unit credit method. When the calculation results in a potential asset for the Bank, the recognised asset is limited to the present value of economic benefits available in the form of any future refunds from the plan or reductions in future contributions to the plan.

Remeasurements of the net defined benefit liability, which comprise actuarial gains and losses, the return on plan assets (excluding interest) and the effect of the asset ceiling (if any, excluding interest), are recognised immediately in other comprehensive income (OCI). The Bank determines the net interest expense (income) on the net defined benefit liability (asset) for the period by applying the discount rate used to measure the defined benefit obligation at the beginning of the annual period to the then net defined benefit liability (asset), taking into account any changes in the net defined liability (asset) during the period as a result of contributions and benefit payments. Net interest expense and other expenses related to the defined benefit plan are recognised in the statement of income.

Retirement expense under the defined benefit plan is also recognised as part of "Compensation and personnel-related costs" in the statement of income.

When the benefits of a plan are changed or when a plan is curtailed, the resulting change in benefit that relates to past service or the gain or loss on curtailment is recognised immediately in the statement of income.
The Bank recognises gains and losses on the settlement of a defined benefit plan when the settlement occurs.

Under the defined contribution plan, the contribution payable to the plan is proportionate to the credit services of the beneficiaries as defined in the Bank's retirement plan and is recorded as an expense under "Compensation and personnel-related costs" in the statement of income. Unpaid contribution is recorded under "Accrued expenses and other liabilities" in the statement of financial position.

The Bank, however, is covered under Republic Act (RA) No. 7641, The Philippine Retirement Pay Law, which provides for its qualified employees a defined benefit minimum guarantee. The defined benefit minimum guarantee is equivalent to a certain percentage of the monthly salary payable to an employee at normal retirement age with the required credited years of service based on the provisions of RA No. 7641.

Accordingly, the Bank accounts for its retirement obligation under the higher of the defined benefit obligation relating to the minimum guarantee and the obligation arising from the defined contribution plan.

For the defined benefit minimum guarantee plan, the liability is determined based on the present value of the excess of the projected defined benefit obligation over the projected defined contribution obligation at the end of the reporting period. The defined benefit obligation is calculated annually by a qualified independent actuary using the projected unit credit method. The Bank determines the net interest expense (income) on the net defined benefit liability (asset) for the period by applying the discount rate used to measure the defined benefit obligation at the beginning of the annual period to the then net defined benefit liability (asset), taking into account any changes in the net defined benefit liability (asset) during the period as a result of contributions and benefit payments. Net interest expense and other expenses related to the defined benefit plan are recognised in the statement of income.

The defined contribution liability, on the other hand, is measured at the fair value of the defined contribution assets upon which the defined contribution benefits depend, with an adjustment for margin on asset returns, if any, where this is reflected in the defined contribution benefits.

Termination benefits

Termination benefits are employee benefits provided in exchange for the termination of an employee's employment as a result of either:

- the Bank's decision to terminate an employee's employment before the normal retirement date; or
- an employee's decision to accept an offer of benefits in exchange for the termination of employment.

A liability and expense for termination benefits are recognised at the earlier of the following dates:

(a) when the Bank can no longer withdraw the offer of those benefits; and
(b) when the Bank recognises costs for a restructuring that is within the scope of PAS 37, '*Provisions, Contingent Liabilities and Contingent Assets'* and involves the payment of termination benefits.

Short-term benefits

Short-term benefits are those employee benefits (other than termination benefits) that are expected to be settled wholly within 12 months after the end of the annual reporting period in which the employees render the related service.

A short-term employee benefit does not need to be reclassified if the expectations of the timing of settlement change temporarily. However, if the characteristics of the benefit change (such as a change from a non-accumulating benefit to an accumulating benefit) or if a change in expectations of the timing of settlement is not temporary, then it needs to be considered whether the benefit still meets the definition of short-term employee benefits.

Short-term benefits for services received from employees are recognised as an expense during the accounting period in which employee service is rendered, unless another PFRS requires or permits the benefits to be included in the cost of an asset. Any difference between the expense recognised and cash payments made is recognised as a liability or prepayment as appropriate. The expense recognised should be undiscounted.

5.12 Provisions

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

5.13 Contingencies

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of the Bank; or are present obligations that have arisen from past events but are not recognised because it is not probable that settlement will require the outflow of economic benefits, or because the amount of the obligations cannot be reliably measured. Contingent liabilities are not recognised in the financial statements but are disclosed unless the probability of settlement is remote. Contingent assets are not recognised but are disclosed in the notes to financial statements when an inflow of economic benefits is probable.

5.14 Share-based payments

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 under "Compensation and personnel-related costs" in the statement of income on a straight-line basis over the vesting period with a corresponding credit to "Other reserves". The vesting period is the period during which all the specified vesting conditions of the arrangement are to be satisfied. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using market prices and 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 this condition is satisfied, provided all other vesting conditions are satisfied.

Vesting conditions, other than market performance conditions, are not taken into account in the initial estimate of the fair value at the grant date. They are taken into account by adjusting the number of equity instruments included in the measurement of the transaction, so that the amount recognised for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. On a cumulative basis, no expense is recognised for equity instruments that do not vest because of a failure to satisfy non-market performance or service conditions.

Where an award has been modified, as a minimum, the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of the extra equity instruments is recognised in addition to the expense of the original grant, measured at the date of modification, over the modified vesting period.

A cancellation that occurs during the vesting period is treated as an acceleration of vesting and recognised immediately for the amount that would otherwise have been recognised for services over the remaining vesting period.

5.15 Income taxes

(a) Current income tax

Income tax payable is calculated on the basis of the applicable tax law and is recognised as an expense for the year except to the extent that current tax is related to items (for example, current tax on financial assets at FVOCI and available-for-sale financial assets) that are charged or credited to other comprehensive income or directly to capital funds.

The Bank has substantial income from its investment in government securities subject to final withholding tax. Such income is presented at its gross amount and the final tax paid or withheld is included in “income tax expense” in the statement of income.

(b) Deferred income tax

Deferred income tax is recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. The deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction, other than a business combination, that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates and laws that have been enacted or substantively enacted at the reporting date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Deferred income tax assets are recognised for all deductible temporary differences, carry-forward of unused tax losses (net operating loss carryover or NOLCO) and unused tax credits (excess minimum corporate income tax or MCIT) to the extent that it is probable that future taxable profit will be available against which the temporary differences, unused tax losses and unused tax credits can be utilised. Deferred income tax liabilities are recognised in full for all taxable temporary differences except to the extent that the deferred tax liability arises from the initial recognition of goodwill.

The Bank reassesses at each reporting date the need to recognise a previously unrecognised deferred income tax asset.

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes assets and liabilities relate to income taxes levied by the same taxation authority on either the taxable entity or different taxable entities where there is an intention to settle the balances on a net basis.

5.16 Equity

Share capital is measured at par value for all shares issued and outstanding. When the shares are sold at a premium, the difference between the proceeds and the par value is credited to “Additional paid-in capital”. Direct costs incurred related to equity issuance, such as underwriting, accounting and legal fees, printing costs and taxes are chargeable to “Additional paid-in capital” account. If the additional paid-in capital is not sufficient, the excess is charged to retained earnings.

“Retained earnings” represents the accumulated earnings of the Bank.

Dividends on common shares are recognised as a liability and deducted from equity when approved by the BOD of the Bank and the BSP, in the case of cash dividends; and the BOD, shareholder of the Bank and the BSP in the case of stock dividends. Dividends declared during the year but are approved by the BSP after the reporting date is dealt with as an event after the reporting period.

5.17 Related party relationships and transactions

Related party relationship exists when one party has the ability to control, directly, or indirectly through one or more intermediaries, the other party or exercises significant influence over the other party in making financial and operating decisions. Such relationship also exists between and/or among entities which are under common control with the reporting enterprise, or between and/or among the reporting enterprise and its key management personnel, directors, or its shareholder. In considering each possible related party relationship, attention is directed to the substance of the relationship, and not merely the legal form.

5.18 Events after the reporting date

Any post year-end events that provides additional information about the Bank’s financial position at the reporting date (adjusting event) is reflected in the financial statements when material. Post year-end events that are not adjusting events, if any, are disclosed in the notes to the financial statements when material.

6 Capital and financial risk management

The Bank, being a wholly-owned subsidiary of the Parent Company, is part of the HSBC Group, which is incorporated in the Hong Kong Special Administrative Region (SAR).

All of the Bank’s activities involve, to varying degrees, the measurement, evaluation and management of risk or combinations of risks.

Our conservative risk profile
The Bank maintains a conservative risk profile which encompasses the following:

Financial position

- Strong capital position, defined by regulatory and internal capital ratios.
- Liquidity and funding management for each operating entity, on a stand-alone basis.

Operating model

- Returns generated in line with risk taken.
- Sustainable and diversified earnings mix, delivering consistent returns for shareholder.

Business practice
- Zero tolerance for knowingly engaging in any business, activity or association where foreseeable reputational risk or damage has not been considered and/or mitigated.
- No appetite for deliberately or knowingly causing detriment to consumers arising from our products and services or incurring a breach of the letter or spirit of regulatory requirements.
- No appetite for inappropriate market conduct by a member of staff or by any HSBC Group business.

The risk management framework established by the HSBC Group seeks to foster the continuous monitoring of the risk environment and an integrated evaluation of risks and their interdependencies.

6.1 Risk management framework

Managing risk effectively is fundamental to the delivery of our strategic priorities. In doing so, the Bank employs a risk management framework at all levels of the organisation and across all risk types. It fosters the continuous monitoring of the risk environment and an integrated evaluation of risks and their interactions. It also ensures that there is a consistent approach to risk management across the Bank.

The Bank's enterprise risk management framework is underpinned by its risk culture and is reinforced by the HSBC Values and Global Standards. These are instrumental in aligning the behaviours of individuals with the Bank's attitude to assuming and managing risk and helping to ensure that risk profile remains in line with the Bank's risk appetite.

6.1.1 Credit risk management

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. Credit risk arises principally from direct lending, trade finance and from certain other products such as guarantees and derivatives.

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 Bank of the contract and the expected potential change in that value over time caused by movements in market rates;
- **monitored** within limits approved by individuals within a framework of delegated authorities. These limits represent the peak exposure or loss to which the Bank could be subjected should the customer or counterparty fail to perform its contractual obligations; and
- **managed** through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.

There were no material changes in the policies and practices for the management of credit risk in 2018.

Adoption of PFRS 9 *'Financial Instruments'*

The Bank adopted the requirements of PFRS 9, *'Financial Instruments'* on January 1, 2018. The adoption of PFRS 9 did not result in any significant change to the Bank's business model. This included the Bank's strategy, country of risk presence, product offerings and target customer segments.

The Bank has established credit risk management processes. The impact of economic developments on specific customers, customer segments or portfolios are actively assessed. If the Bank foresees changes in credit conditions, mitigating action, including the revision of risk appetites or limits and tenors, as appropriate are being taken. In addition, the Bank continues to evaluate the terms under which credit facilities within the context of individual customer requirements, the quality of the relationship, regulatory requirements, market practices and market position are provided

As a result of PFRS 9 adoption, management has additional insights and measures not previously utilised which, over time, may influence the Bank's risk appetite and risk management processes.

Comparative credit tables provided and disclosed in the succeeding pages are not directly comparable as the Bank chooses not to restate the prior period in accordance with the exemption provided in PFRS 9.

PFRS 9 process

The PFRS 9 process comprises three main areas: modelling and data; implementation; and governance.

Modelling and data

Prior to the implementation of PFRS 9, the Risk function had pre-existing behavioural scorecards. These were then enhanced or supplemented to address the PFRS 9 requirements, with the appropriate governance and independent review.

Implementation

A centralised impairment engine performs the expected credit loss ('ECL') calculation using data, which is subject to a number of validation checks and enhancements, from a variety of client, finance and risk systems. Where possible, these checks and processes are performed in a globally consistent and centralised manner. Management implements series of controls to ensure that the centrally calculated ECL complies with the local regulatory requirements.

Governance

A series of regional management review forums has been established in key sites and regions in order to review and approve the impairment results. Regional management review forums have representatives from Credit Risk and Finance. The key site and regional approvals are reported up to the global business impairment committee for final approval of the Bank's ECL for the period. Required members of the committee are the global heads of Wholesale Credit, Market Risk, and Retail Banking and Wealth Management (RBWM) Risk, as well as the global business Chief Financial Officers (CFOs) and the Group Chief Accounting Officer (CAO). These are supplemented by the local review and challenge controls surrounding the monthly Country Impairment Forum which are attended by the local key management such as Head of RBWM Risk, Head of RBWM, the CFO and CAO.

Maximum exposure to credit risk

The following table shows the maximum exposure to on- and off-balance sheet credit risk (including derivatives) of the Bank without considering the effects of collateral, credit enhancements and other credit risk mitigation techniques:

	2018	2017
On-balance sheet items		
Due from BSP	913,800	3,698,433
Due from others banks	1,337,086	1,848,574
Interbank loans receivable and SPURA	631,877	417,919
	2,882,763	5,964,926
Financial assets at FVTPL		
Derivative assets	15	7
Financial assets at FVOCI		
Government	7,906,317	N/A
AFS financial assets		
Government	N/A	6,344,394
Loans and receivables, net		
Personal loans	2,410,071	2,673,099
Accrued interest receivable	78,829	70,504
Accounts receivable	1,558	8,961
	2,490,458	2,752,564
Other assets - refundable deposits and RCOCI	17,255	15,066
Off-balance sheet item		
Undrawn loan commitments, net	14,953	55,096
	13,311,761	15,132,053

Concentrations of risks of financial assets with credit risk exposure

Concentrations of credit risk arise when a number of counterparties or exposures have comparable economic characteristics or such counterparties are engaged in similar activities or operate in the same geographical areas or industry sectors so that their collective ability to meet contractual obligations is uniformly affected by changes in economic, political or other conditions. The Bank uses a number of controls and measures to minimise undue concentration of exposure in our portfolios across industry, country and global business. These include portfolio and counterparty limits, approval and review controls, and stress testing.

Wrong-way risk occurs when a counterparty's exposures are adversely correlated with its credit quality.

There are two types of wrong-way risk:

- general wrong-way risk occurs when the probability of counterparty default is positively correlated with general risk factors such as, for example, where the counterparty is resident and/or incorporated in a higher-risk country and seeks to sell a non-domestic currency in exchange for its home currency; and
- specific wrong-way risk occurs when the exposure to a particular counterparty is positively correlated with the probability of counterparty default, such as a reverse repo on the counterparty's own bonds. It is our policy that specific wrong-way transactions are approved on a case-by-case basis.

The Bank uses a range of tools to monitor and control wrong-way risk, including requiring the business to obtain prior approval before undertaking wrong-way risk transactions outside pre-agreed guidelines.

Concentration by industry

The tables below show the industry sector analysis of the Bank's financial assets in gross amounts, without taking into account the fair value of the loan collateral held or other credit enhancements.

2018	Loans and Receivables[a]	Loans and Advances to Banks[b]	Investment Securities	Others[c]	Total
Sovereigns	69,461	989,800	7,906,317	-	8,965,578
Financial intermediaries	223	1,893,017	15	-	1,893,255
Private households with employed persons (various)	2,438,681	-	-	14,953	2,453,634
Electricity, gas and water	-	-	-	15,819	15,819
Others	1,558	-	-	1,436	2,994
	2,509,923	2,882,817	7,906,332	32,208	13,331,280
Less: Allowance for credit and impairment losses	19,465	54	-	-	19,519
	2,490,458	2,882,763	7,906,332	32,208	13,311,761

2017	Loans and Receivables[a]	Loans and Advances to Banks[b]	Investment Securities	Others[c]	Total
Sovereigns	60,313	3,751,302	6,344,401	55,096	10,211,112
Financial intermediaries	47	2,213,624	-	-	2,213,671
Private households with employed persons (various)	2,696,744	-	-	1,494	2,698,238
Electricity, gas and water	-	-	-	13,572	13,572
Others	8,960	-	-	-	8,960
	2,766,064	5,964,926	6,344,401	70,162	15,145,553
Less: Allowance for credit and impairment losses	13,500	-	-	-	13,500
	2,752,564	5,964,926	6,344,401	70,162	15,132,053

[a]*Consists of Loans, Accrued interest receivable and Accounts receivable*
[b]*Consists of Due from BSP, Due from other banks and Interbank loans receivable and SPURA*
[c]*Consists of Refundable deposits, RCOCI and Undrawn loan commitments*

The BSP considers that concentration of credit risk exists in the Bank when total loan exposure to a particular industry or economic sector exceeds 30.00% of the total loan portfolio.

Credit quality of financial assets

Credit quality classification

The credit risk rating systems and processes differentiate exposures in order to highlight those with greater risk factors and higher potential severity of loss. Risk is assessed and managed using a wide range of risk and pricing models to generate portfolio data.

The risk rating system facilitates the internal ratings - based approach under the Basel framework adopted by the Bank to support calculation of our minimum credit regulatory capital requirement. The credit quality classifications are defined below.

The five credit quality classifications defined below each encompasses a range of granular internal credit rating grades assigned to retail lending businesses and the external ratings attributed by external agencies to debt securities. Under PAS 39, retail lending credit quality was disclosed based on expected-loss percentages. Under PFRS 9, retail lending credit quality is now disclosed based on a 12-month probability-weighted PD.

Risk rating scales

Quality classification	Debt securities and other bills	Retail lending	
	External credit rating	Internal credit rating	12-month probability-weighted PD %
Strong	A- and above	EL1 to EL2	0.000 - 0.500
Good	BBB+ to BBB-	EL3	0.501 - 1.500
Satisfactory	BB+ to B and unrated	EL4 to EL5	1.501 - 20.000
Sub-standard	B- to C	EL6 to EL8	20.001 - 99.999
Impaired	Default	EL9 to EL10	100.000

Credit quality classification definitions:

- “Strong” exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.
- “Medium - good” exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minimal following the adoption of recovery processes.
- “Medium - satisfactory” exposures require closer monitoring and demonstrate an average to fair capacity to meet financial commitments, with moderate default risk. Retail accounts typically show only short-periods of delinquency, with any losses expected to be minor following the adoption of recovery processes.
- “Sub-standard” exposures require varying degrees of special attention and default risk is of greater concern. Retail portfolio segments show longer delinquency periods generally up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate these through security realisation or other recovery processes.
- “Impaired” exposures have been assessed, individually or collectively, as impaired. All products under retail lending, which are more than 90 days past due and with EL band nine (9) to ten (10) are classified as impaired.
- Unrated exposures are those financial instruments other than debt instruments that could not be classified as strong, medium-good, medium-satisfactory, substandard or impaired.

The customer risk rating (‘CRR’) 10-grade scale summarises a more granular underlying 23-grade scale of obligor PD. All customers are rated using the 10 or 23-grade scale, depending on the degree of sophistication adopted for the exposure.

Each CRR band is associated with an external rating grade by reference to long-run default rates for that grade, represented by the average of issuer-weighted historical default rates. This mapping between internal and external ratings is indicative and may vary over time.

The EL 10-grade scale for retail business summarises a more granular underlying EL scale for this customer segment; this combines obligor and facility/product risk factors in a composite measure.

Impairment is not measured for financial instruments held in trading portfolios or designated at fair value, as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly through the statement of income.

The tables below show the credit quality by class of financial assets subject to impairment and the related allowance for credit and impairment losses, based on the Bank's credit rating system:

	Stage 1	Stage 2	Stage 3	Total	Allowance for credit and impairment loss	Net
Due from BSP						
Strong	913,800	-	-	913,800	-	913,800
Good	-	-	-	-	-	-
Satisfactory	-	-	-	-	-	-
Substandard	-	-	-	-	-	-
Credit impaired	-	-	-	-	-	-
	913,800	-	-	913,800	-	913,800
Due from other banks						
Strong	1,337,103	-	-	1,337,103	50	1,337,053
Good	33	-	-	33	-	33
Satisfactory	-	-	-	-	-	-
Substandard	-	-	-	-	-	-
Credit impaired	-	-	-	-	-	-
	1,337,136	-	-	1,337,136	50	1,337,086
Interbank loans receivable and SPURA						
Strong	631,881	-	-	631,881	4	631,877
Good	-	-	-	-	-	-
Satisfactory	-	-	-	-	-	-
Substandard	-	-	-	-	-	-
Credit impaired	-	-	-	-	-	-
	631,881	-	-	631,881	4	631,877
Financial assets at FVTPL						
Strong	15	-	-	15	-	15
Good	-	-	-	-	-	-
Satisfactory	-	-	-	-	-	-
Substandard	-	-	-	-	-	-
Credit impaired	-	-	-	-	-	-
	15	-	-	15	-	15
Financial assets at FVOCI						
Strong	6,806,049	-	-	6,806,049	-	6,806,049
Good	1,100,268	-	-	1,100,268	-	1,100,268
Satisfactory	-	-	-	-	-	-
Substandard	-	-	-	-	-	-
Credit impaired	-	-	-	-	-	-
	7,906,317	-	-	7,906,317	-	7,906,317
Loans and receivables						
Strong	102,824	-	-	102,824	670	102,154
Good	1,904,584	-	-	1,904,584	431	1,904,153
Satisfactory	284,258	135,875	-	420,133	8,168	411,965
Substandard	-	35,499	-	35,499	4,876	30,623
Credit impaired	-	-	46,883	46,883	5,320	41,563
	2,291,666	171,374	46,883	2,509,923	19,465	2,490,458
Other assets - Refundable deposits and RCOCI						
Strong	-	-	-	-	-	-
Good	-	-	-	-	-	-
Satisfactory	-	-	-	-	-	-
Substandard	-	-	-	-	-	-
Credit impaired	-	-	-	-	-	-
Unrated	17,255	-	-	17,255	-	17,255
	17,255	-	-	17,255	-	17,255

(forward)

	Stage 1	Stage 2	Stage 3	Total	Allowance for credit and impairment loss	Net
Off-balance sheet items						
Commitments						
Strong	7,176	-	-	7,176	-	7,176
Good	1,219	-	-	1,219	-	1,219
Satisfactory	5,142	970	-	6,112	-	6,112
Substandard	-	324	-	324	-	324
Credit impaired	-	-	122	122	-	122
Unrated	-	-	-	-	-	-
	13,537	1,294	122	14,953	-	14,953
December 31, 2018	13,111,607	172,668	47,005	13,331,280	19,519	13,311,761

Renegotiation

The Bank sometimes modifies the terms of loans provided to customers due to commercial renegotiations, or for distressed loans, with a view to maximising recovery. Such restructuring activities include extended payment term arrangements, payment holidays and payment forgiveness. Restructuring policies and practices are based on indicators or criteria which, in the judgment of management, indicate that payment will most likely continue. These policies are kept under continuous review.

There are no financial assets with lifetime ECL which cash flows were modified during 2018 as part of the Bank's restructuring activities.

There are no restructured financial assets that moved from Stage 3 (Lifetime ECL) to Stage 1 (12-month ECL) during the year.

Loss allowance

The following disclosure provides a reconciliation by stage of the Bank's allowance for credit and impairment losses, including loan commitments and financial assets at FVOCI.

The transfers of financial instruments represent the impact of stage transfers and allowance for credit and impairment losses. The net remeasurement of allowance for credit and impairment losses arising from stage transfers represents the increase or decrease due to these transfers, for example, moving from a 12-month (stage 1) to a lifetime (stage 2) ECL measurement basis. Net remeasurement excludes the underlying CRR/PD movements of the financial instruments transferring stage. This is captured, along with other credit quality movements in the 'changes in risk parameters' line item.

The 'Net new and further lending/repayments' represent the associated allowance for credit and impairment losses impact from volume movements within the Bank's lending portfolio.

Summary views of the movement are presented succeeding pages.

	Non credit impaired		Credit impaired		
	Stage 1	Stage 2	Stage 3	POCI	Gross carrying amount[a]
At January 1, 2018	57,363,114	439,181	59,769	-	57,862,064
Changes to risk parameters (model inputs)	(55,049,084)	(31,297)	355	-	(55,080,026)
Asset derecognised (including final repayments)	(10,428)	(235,216)	(11,518)	-	(257,162)
At December 31, 2018	2,303,602	172,668	48,606	-	2,524,876

[a]Consists of loans and receivables and commitments

	Non credit impaired		Credit impaired		
	Stage 1	Stage 2	Stage 3	POCI	Allowance for credit and impairment loss[b]
At January 1, 2018	6,987	12,324	4,166	-	23,477
Transfers of financial instruments					-
From Stage 1 to Stage 2	(680)	680	-	-	-
From Stage 2 to Stage 1	633	(633)	-	-	-
From Stage 2 to Stage 3	-	(1,093)	1,093	-	-
From Stage 3 to Stage 2	-	296	(296)	-	-
	6,940	11,574	4,963	-	23,477
New financial assets originated	7,157	-	-	-	7,157
Changes to risk parameters (model inputs)	47	750	358	-	1,155
Asset derecognised (including final repayments)	(7,568)	(4,756)	-	-	(12,324)
Assets written off	-	-	-	-	-
At December 31, 2018	6,576	7,568	5,321	-	19,465

[b]Consists of allowance for credit and impairment losses for loans and receivables

As shown in the above table, the allowance for credit and impairment losses for loans and receivables decreased from P23.5 million at January 1, 2018 to P19.5 million at December 31, 2018.

This overall decrease was primarily driven by P12.3 million relating to underlying net book volume movements, which included the ECL allowance associated with final repayments. The decrease was partially offset by P7.1 million new financial assets that originated.

Loans and advances to banks

The movement in loans and advances to banks, which comprise of due from BSP, due from other banks, and interbank loans receivable and SPURA, from P5,965 million as at January 1, 2018 to P2,883 million as at December 31, 2018 pertains to the net maturities during the year.

The resulting movement in allowance for credit and impairment losses for these loans and advances to banks from P195 thousands as at January 1, 2018 to P54 thousands as at December 31, 2018 pertains to the net effect of asset derecognition and changes in risk parameters as inputs to the ECL calculation model. There are no loans and advances to banks transferred between stages in 2018. Consequently, the allowance for credit and impairment loss for these assets are all measured under stage 1.

Forward-looking information incorporated in the ECL models

The key forward-looking judgments and assumptions adopted by the Bank in addressing the requirements of PFRS 9 are discussed in the subsequent sections.

Consensus Central scenario

The following table describes key macroeconomic variables and the probabilities assigned in the Consensus Central scenario.

Central scenario (average 2019 - 2023)	
GDP growth rate (%)	5.8
Inflation (%)	3.6
Unemployment (%)	5.0
Short term interest rate (%)	4.9
Property price growth (%)	9.8
Probability (%)	80.0

Consensus Upside scenario

Globally, real GDP growth rises in the first two years of the Upside scenario before converging to the Central scenario. Increased confidence, de-escalation of trade tensions and removal of trade barriers, expansionary fiscal policy, stronger oil prices as well as calming of geopolitical tensions are the risk themes that support the 2018 year-end Upside scenario.

The following table describes key macroeconomic variables and the probabilities assigned in the consensus Upside scenario.

Upside scenario (average 2019 - 2023)	
GDP growth rate (%)	6.1
Inflation (%)	4.0
Unemployment (%)	4.8
Short term interest rate (%)	5.1
Property price growth (%)	10.5
Probability (%)	10.0

Consensus Downward scenario

Globally, real GDP growth declines for two years in the Downside scenario before recovering to the Central scenario. House price growth either stalls or contracts and equity markets correct abruptly in our major markets. The global slowdown in demand drives commodity prices lower and results in an accompanying fall in inflation. This is consistent with the key risk themes of the downside, such as an intensification of global protectionism and trade barriers, faster than expected tightening of Fed policy rate, China choosing to rebalance with stringent measures, and weaker commodity prices.

Downward scenario (average 2019 - 2023)	
GDP growth rate (%)	5.5
Inflation (%)	3.1
Unemployment (%)	5.3
Short term interest rate (%)	3.2
Property price growth (%)	8.2
Probability (%)	5.0

Global Trade War scenario

Continued escalation of trade- and tariff-related tensions throughout 2018 resulted in management modelling deeper effects of a trade war scenario than currently captured by the consensus Downside scenario. This additional trade war scenario models the effects of a significant escalation in global tensions, stemming from trade disputes but going beyond increases in tariffs to affect non-tariff barriers, cross-border investment flows and threatens the international trade architecture. This scenario assumes actions that lie beyond currently enacted and proposed tariffs and has been modelled as an addition to the three consensus-driven scenarios for these economies. This scenario has been assigned a 5% weight, leaving 5% assigned to the consensus Downside scenario, and has been used in addition to the consensus economic scenarios for the Bank.

Key macro-economic variables are shown in the table below:

Global Trade War scenario (average 2019 - 2023)	
GDP growth rate (%)	5.1
Short term interest rate (%)	2.5
Probability (%)	5.0

Economic scenarios sensitivity analysis of ECL estimates

The ECL outcome is sensitive to judgment and estimations made with regard to the formulation and incorporation of multiple forward-looking economic conditions described above. As a result, management assessed and considered the sensitivity of the ECL outcome against the forward-looking economic conditions as part of the ECL governance process by recalculating the ECL under each scenario described above applying a 100% weighting to each scenario in turn. The weighting is reflected in both the determination of significant increase in credit risk as well as the measurement of the resulting ECL.

The economic scenarios are generated to capture the Bank's view of a range of possible forecast economic conditions that is sufficient for the calculation of unbiased and probability-weighted ECL. Therefore, the ECL calculated for each of the scenarios represent a range of possible outcomes that have been evaluated to estimate ECL. As a result, the ECL calculated for the Upside and Downside scenarios should not be taken to represent the upper and lower limits of possible actual ECL outcomes. There is a high degree of estimation uncertainty in numbers representing tail risk scenarios when assigned a 100% weighting, and an indicative range is provided for the tail risk sensitivity analysis. A wider range of possible ECL outcomes reflects uncertainty about the distribution of economic conditions and does not necessarily mean that credit risk on the associated loans is higher than for loans where the distribution of possible future economic conditions is narrower. The recalculated ECL for each of the scenarios should be read in the context of the sensitivity analysis as a whole and in conjunction with the narrative disclosures provided below.

ECL under each scenario is presented in thousands of PHP and as a percentage of the gross carrying amount.

Retail

	2018
ECL coverage of loans and receivables	
Reported ECL	19,465
Gross carrying amount	2,509,923
Reported ECL coverage	0.78%
Coverage ratios by scenario	
Consensus Central scenario	0.77%
Consensus Upside scenario	0.74%
Consensus Downside scenario	0.79%
Coverage ratios for alternative scenario	
US-China Tradewar	0.80%

Loans and advances to banks and investment securities

	2018
ECL coverage of loans and advances to banks and investment securities	
Reported ECL	552
Gross carrying amount	10,789,149
Reported ECL coverage	0.01%
Coverage ratios by scenario	
Consensus Central scenario	0.01%
Consensus Upside scenario	0.00%
Consensus Downside scenario	0.01%

Refer to Note 14 for the movements of the Bank's allowance for credit and impairment losses.

Offsetting financial assets and financial liabilities

Pursuant to the amendments to PFRS 7 requiring the Bank to disclose information about rights to offset and related arrangements, the Bank's financial assets and liabilities subject to offsetting, enforceable master netting arrangements and similar agreements as at December 31, 2018 are derivative transactions, which are not significant as at December 31, 2018 and 2017.

There are no collaterals held by the Bank for derivative contracts as at December 31, 2018 and 2017.

2017 credit risk disclosures

The disclosures below were included in the 2017 financial statements and do not reflect the adoption of PFRS 9. As these are not directly comparable to the 2018 disclosures which are disclosed on the basis of PFRS 9, these disclosures have been shown below and not adjacent to 2018 disclosures.

	Neither Past Due nor Impaired				Past Due but not Impaired					
		Medium			Medium					
2017	Strong	Good	Satisfactory	Sub-standard	Good	Satisfactory	Sub-standard	Impaired	Unrated	Total
Due from BSP	-	3,698,433	-	-	-	-	-	-	-	3,698,433
Due from other banks	1,444,729	403,845	-	-	-	-	-	-	-	1,848,574
Interbank loans receivable	365,050	52,869	-	-	-	-	-	-	-	417,919
	1,809,779	4,155,147	-	-	-	-	-	-	-	5,964,926
Derivative assets	-	-	-	-	-	-	-	-	7	7
AFS financial assets										
Debt securities			-	-	-	-	-	-		
Government securities	2,981,567	3,362,827	-	-	-	-	-	-	-	6,344,394
Loans and receivables										
Personal loans	2,477,935	-	-	-	131,589	21,555	13,992	41,528	-	2,686,599
Accrued interest receivable	25,396	45,108	-	-	-	-	-	-	-	70,504
Accounts receivable	1,750	568	80	115	-	-	-	-	6,448	8,961
	2,505,081	45,676	80	115	131,589	21,555	13,992	41,528	6,448	2,766,064
Other assets - refundable deposits and RCOCI	-	-	-	-	-	-	-	-	15,066	15,066
Off-balance sheet items										
Commitments	53,414	868	110	704	-	-	-	-	-	55,096
	7,349,841	7,564,518	190	819	131,589	21,555	13,992	41,528	21,521	15,145,553

The Bank's impaired loans and receivables secured by collaterals as at December 31, 2017 amount to P40.37 million. The aggregate fair value of collaterals held by the Bank pertaining to the aggregate amount of impaired loans and receivables as at December 31, 2017 amount to P105.21 million.

The table below shows the aging analysis of past due but not impaired loans and receivables per class that the Bank holds. Under PFRS 7, a financial asset is past due when a counterparty has failed to make a payment when contractually due.

	Past Due but not Impaired			
	Less than 30 Days	30 to 59 Days	60 to 89 Days	Total
2017				
Personal loans	131,589	21,555	13,992	167,136

6.2 Liquidity risk and funding management

Liquidity and funding risk is the risk that the Bank does not have sufficient financial resources to meet our obligations as they fall due or that the Bank can only do so at excessive cost.

Liquidity and Funding Risk management aims to ensure that liquidity resources are adequate, both as to the amount and quality, to ensure that there is no significant risk that liabilities cannot be met as they fall due, and to ensure that a prudent structural funding profile is maintained.

Liquidity and funding risk is:

- **measured** using internal metrics the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR);
- **monitored** against the Group's liquidity and funding risk framework and overseen by regional Asset and Liability Management Committees ('ALCO's), Group ALCO and the Risk Management Meeting; and
- **managed** on a stand-alone basis with no reliance on any Group entity (unless pre-committed) or central bank unless this represents routine established business-as-usual market practice.

The tables below show the maturity profile of the Bank's financial instruments based on contractual undiscounted repayment obligations before allowance for credit and impairment loss.

	2018			
	Up to 1 year	1 to 5 years	Beyond 5 years	Total
Financial Assets				
Cash and other cash items	197,666	-	-	197,666
Due from BSP	913,800	-	-	913,800
Due from other banks	1,337,086	-	-	1,337,086
Interbank loans receivable and SPURA	632,133	-	-	632,133
Financial assets at FVTPL	15	-	-	15
Financial assets at FVOCI	5,303,979	2,634,678	-	7,938,657
Loans and receivables	260,858	621,694	1,627,371	2,509,923
Other assets	7,996	5,228	4,031	17,255
Total undiscounted financial assets	8,653,533	3,261,600	1,631,402	13,546,535
Financial Liabilities				
Deposit liabilities				
Demand	2,530,874	-	-	2,530,874
Savings	7,397,525	-	-	7,397,525
Time	1,788,264	-	-	1,788,264
Financial liabilities at FVTPL	4	-	-	4
Bills payable	79,761	-	-	79,761
Cashier's orders	40,512	-	-	40,512
Accrued expenses and other liabilities				
Accounts payable	6,086	-	-	6,086
Accrued other expenses	20,845	-	-	20,845
Unclaimed balances	61,465	-	-	61,465
Accrued interest	1,446	-	-	1,446
Total undiscounted financial liabilities	11,926,782	-	-	11,926,782
Total maturity gap	(3,273,249)	3,261,600	1,631,402	1,619,753

	2017			
	Up to 1 year	1 to 5 years	Beyond 5 years	Total
Financial Assets				
Cash and other cash items	168,148	-	-	168,148
Due from BSP	3,699,858	-	-	3,699,858
Due from other banks	1,848,574	-	-	1,848,574
Interbank loans receivable and SPURA	417,984	-	-	417,984
Financial assets at FVTPL	7	-	-	7
AFS financial assets	2,981,567	3,776,925	-	6,758,492
Loans and receivables	279,289	899,089	3,225,693	4,404,071
Other assets	2,613	4,297	8,156	15,066
Total undiscounted financial assets	9,398,040	4,680,311	3,233,849	17,312,200
Financial Liabilities				
Deposit liabilities				
Demand	3,045,413	-	-	3,045,413
Savings	7,888,777	-	-	7,888,777
Time	2,444,883	-	-	2,444,883
Financial liabilities at FVTPL	17	-	-	17
Bills payable	30,311	-	-	30,311
Cashier's orders	53,429	-	-	53,429
Accrued expenses and other liabilities				
Accounts payable	8,793	-	-	8,793
Accrued other expenses	55,480	-	-	55,480
Unclaimed balances	51,683	-	-	51,683
Accrued interest	554	-	-	554
Total undiscounted financial liabilities	13,579,340	-	-	13,579,340
Total maturity gap	(4,181,300)	4,680,311	3,233,849	3,732,860

The tables above incorporate all cash flows, on an undiscounted basis, related to principal as well as those associated with all future coupon payments.

As at December 31, 2018, the Bank's undrawn loan commitments amounting to P14.95 million (2017 - P55.1 million) are payable upon demand (Note 25).

6.3 Market risk

Market risk is the risk that the market rates and prices - interest rates, exchange rates, etc - will move adversely relative to positions taken causing losses to the Bank's portfolios.

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 the Bank's retail, financial investments designated as available for sale.

Market risk is:

- **measured** in terms of value at risk, which is used to estimate potential losses 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, augmented 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;
- **monitored** using measures including the sensitivity of net interest income and the sensitivity of structural foreign exchange which are applied to the market risk positions within each risk type; and
- **managed** using risk limits approved by the Group Management Board ("GMB") for the Ultimate Parent Company and various global businesses. These units are allocated across business lines and to the HSBC Group's legal entities.

6.3.1 Market risk - Trading

Value at Risk

Value-at-Risk (VaR) 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. It is based on historical simulation and calculated on a daily basis. This model derives plausible future scenarios from past series of recorded market rates and prices, taking account of inter-relationships between different markets and rates such as interest rates and foreign exchange rates.

The model also incorporates the effect of option features on the underlying exposures.

The historical simulation models incorporate the following features:

- potential market movements are calculated with reference to historical market rates and prices with reference to foreign exchange rates and interest rates, and the associated volatilities from the past 500 days; and
- VaR is calculated to a 99 percent confidence level, for a one-day holding period, and based on exposures outstanding at close of business.

The Bank routinely validates the relevance of its models through backtesting the actual daily profit and loss results, adjusted to remove non-modelled items such as fees and commission, against the corresponding VaR numbers. Statistically, the Bank would expect to see losses in excess of VaR only one percent of the time over the period covered. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

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

- use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- use of a one-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;
- use of a 99 percent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence;
- VaR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VaR is unlikely to reflect loss potential on exposures that only arise under significant market movements.

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

The Bank also applies a wide range of stress testing, both on individual portfolios and on the Bank's consolidated positions.

The VaR for the Bank follows:

	2018				
In USD'000	Total	Trading	Foreign Exchange	Interest Rate	Credit
December 31, 2018	580	51	5	579	-
Average daily	821	127	12	821	-
Highest	1,050	28	28	1,037	-
Lowest	575	3	3	575	-
December 31, 2017	950	13	13	954	6
Average daily	574	13	13	579	19
Highest	950	37	37	954	46
Lowest	244	5	5	250	5

Stress Value at Risk

Stressed VaR is a 99th percentile 10-day VaR calibrated to a one-year period of stress observed in history. Stressed VaR is calculated from a 250-day stressed market conditions which would amount to a worse-case scenario. Stressed VaR must be calculated at least weekly. The stressed VaR measure must be based on inputs calibrated to historical data from a continuous twelve month period of significant financial stress relevant to the portfolio.

Beginning January 1, 2018, SvaR is reported at 1 day holding period.

The SVaR for the Bank follows:

In USD '000	2018	2017
At year end	7	1,088
Average	18	1,192
Highest	42	2,370
Lowest	4	765

6.3.2 Market risk - non-trading

The main market risks to which the Bank is exposed are interest rate risk and foreign currency risk. Exposure to these risks arises from short-term cash balances, funding positions held, investments in long term financial assets and financial liabilities. The objective of the Bank's market risk management strategies are to reduce exposure to these risks and minimise volatility in reported income and cash flows. The Global Markets (GM) Philippines unit monitors and manages the Bank's market risk exposures.

Interest rate risk

The Bank's interest rate exposure originates from its retail borrowing and lending activities as well as treasury trading activities. These exposures are managed by GM Philippines unit under specified limits agreed with the Head Office Executive Committee and Market Risk Management Unit. Interest rate risk arises in both trading positions and accrual books.

In the course of managing interest rate risk, quantitative techniques and simulation models are used, where appropriate, to identify and assess the potential net interest income and market value effects of these interest rate positions in different interest rates scenarios. The primary objective of such interest rate risk management is to limit potential adverse effects of interest rate movements on net interest income.

This is done by modelling the impact of various changes in interest rates to the Bank's interest related income and expenses.

Present value basis points (PVBP) is the Bank's primary methodology for interest rate risk measurement in its non-discretionary trading books.

Sensitivity of net interest income

A principal part of the Bank's management of market risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The Bank aims, through its management of market risk in non-trading portfolios, to mitigate the effect of prospective interest rate movements which could reduce future net interest income, while balancing the cost of such hedging activities on the current net revenue stream.

For simulation modelling, businesses use a combination of scenarios relevant to local businesses and local markets and standard scenarios which are required throughout the Bank.

The standard scenarios are consolidated to illustrate the combined pro-forma effect on the Bank's consolidated portfolio valuations and net interest income.

The table below sets out the effect on future net interest income of: (a) a parallel movement of plus or minus 100 basis points in all yield curves, and (b) an incremental 25 bps parallel fall or rise in all yield curves at the beginning of each quarter (ramp) during the 12 months. Assuming no management actions, a series of such rises and declines would increase (decrease) planned net interest income of the Bank are as follows:

	2018			2017		
Change in projected net interest income arising from a shift in the yield curves of:	Total	PHP	USD and Others	Total	PHP	USD and Others
Parallel Movements in Yield Curve						
+ 100 bps	44,552	(8,084)	52,636	43,908	57,162	(13,254)
- 100 bps	(56,687)	(194)	(56,493)	(62,945)	(75,002)	12,057
Ramp Movements in Yield Curve						
+ 100 bps	16,399	(6,493)	22,892	66,814	53,078	13,736
- 100 bps	(16,748)	6,814	(23,562)	32,217	1,219	30,998

The interest rate sensitivities set out in the table above are illustrative only and are based on simplified scenarios. The figures represent the effect of the pro-forma movements in net interest income based on the projected yield curve scenarios and the Bank's current interest rate risk profile. This effect, however, does not incorporate actions that would be taken by Balance Sheet Management (BSM) or in the business units to mitigate the impact of this interest rate risk. In reality, BSM proactively seeks to change the interest rate risk profile to minimise losses and optimise net revenues. The projections above also assumes that interest rates of all maturities move by the same amount and, therefore, do not reflect the potential impact on net interest income of some rates changing while others remain unchanged. The projections take account of the anticipated net interest income impact of rate change differences between interbank interest rates and interest rates linked to other bases (such as BSP rates or product rates over which the entity has discretion in terms of the timing and extent of rate changes). The projections make other simplifying assumptions too, including that all positions run to maturity. The impact to net income and equity is equivalent to the impact to net interest income.

Sensitivity of reserves

The Bank monitors the sensitivity of net unrealised gains on AFS financial assets reported as reserves to interest rate movements on a quarterly basis by assessing the expected reduction in valuation of AFS financial assets due to parallel movement of plus or minus 100 bps in all yields curves.

The table below describes the sensitivity of the Bank's reported reserves under "Net unrealised losses on available-for-sale financial assets" in the statement of financial position to these movements:

	2018	2017
Effect of Parallel Movements in Yield Curve		
+100 bps	(54,177)	(85,962)
- 100 bps	54,177	85,962

The sensitivity of reported reserves represents impact on the Bank's statement of total comprehensive income and equity. The above has no impact on the statement of income.

The sensitivities are illustrative only and are based on simplified scenarios. The table shows interest rate risk exposures arising from AFS financial assets which are marked-to-market through reserves. These particular exposures form only a part of the Bank's overall interest rate exposures.

Foreign currency risk

The Bank's foreign exchange exposure arises from its deposit taking, lending and investing activities and foreign exchange trading position.

The Bank adopts a policy of predominantly matching the liabilities with assets in the same currency, effectively reducing the foreign currency exchange rate exposure. Limits are set to ensure that the net foreign currency exposure is kept to an acceptable level and within existing regulatory guidelines.

As at December 31, 2018, net exposure to foreign exchange risk amounts to US$0.20 million net liability (2017 - US$0.26 million net asset).

Presented below is a sensitivity analysis demonstrating the impact on the Bank's pre-tax income and equity of reasonably possible changes in the exchange rate between other currencies and PHP with all other factors constant:

Rate of Change in Exchange Rate	2018	2017
+2.0%	(214)	264
- 2.0%	214	(264)
+1.0%	(107)	132
- 1.0%	107	(132)

6.4 Fair value measurement

The Bank uses the following hierarchy in determining and disclosing the fair value of financial instruments by valuation technique:

- Level 1: quoted (unadjusted) market prices: financial instruments with quoted prices for identical instruments in active markets that the Bank can access at the measurement date.
- Level 2: observable inputs: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.
- Level 3: significant unobservable inputs: financial instruments valued using valuation techniques where one or more significant inputs are unobservable.

(i) *Cash and Other Cash Items, Due from BSP, Due from Other Banks, Interbank Loans Receivable and SPURA and RCOCI Under Other Assets* - Carrying amounts approximate fair values in view of the relatively short-term maturities of these instruments.

(ii) *Debt Securities* - Fair values of debt securities are generally based on quoted market prices. If the market prices are not readily available, fair values are estimated using either values obtained from independent parties offering pricing services or adjusted quoted market prices of comparable investments or using the discounted cash flow methodology at the current market yield.

(iii) *Equity Securities* - Fair values of quoted equity securities are based on quoted prices published in markets. Fair values of unquoted equity securities are carried at cost less allowance for impairment losses due to unpredictable nature of future cash flows and the lack of suitable methods of carrying at a reliable fair value. There is no market for this investment and the Bank does not intend to dispose the investment in the near future.

(iv) *Loans and Receivables and Refundable Deposits under Other* Assets - Fair values of loans and receivables are estimated using the discounted cash flow methodology, using current incremental lending rates for similar types of instruments. Where the instruments reprice on a quarterly basis or have relatively short maturity, the carrying amounts approximate fair values.

(v) *Liabilities* - Fair values are estimated using the discounted cash flow methodology using the Bank's current incremental borrowing rates for similar borrowings with maturities consistent with those remaining for the liability being valued, if any. Except for time deposits, the carrying amounts of deposit liabilities approximate their fair values considering that these are currently due and demandable. The carrying amount of bills payable approximates fair value in view of its short-term maturity.

(vi) *Derivative Instruments* - Fair values are estimated based on quoted market prices and prices provided by independent parties or acceptable valuation models (either based on discounted cash flow techniques or option pricing models, as applicable).

The following tables show an analysis of financial instruments recorded at fair values by level of the fair value hierarchy:

	2018				
	Carrying Value	Level 1	Level 2	Level 3	Total Fair Value
Derivative assets	15	15	-	-	15
Financial assets at FVOCI					
Debt securities					
Government securities	7,906,317	6,814,612	1,091,705	-	7,906,317
Equity securities					
Unquoted	-	-	-	-	-
	7,906,332	6,814,627	1,091,705	-	7,906,332
Assets for which fair values are disclosed					
Loans and receivables	2,490,458	-	-	2,458,698	2,458,698
Other assets - refundable deposit and RCOCI	17,255	-	-	16,547	16,547
	2,507,713	-	-	2,475,245	2,475,245
	10,414,045	6,814,627	1,091,705	2,475,245	10,381,577
Liabilities measured at fair value					
Derivative liabilities	4	4	-	-	4

	2017				
	Carrying Value	Level 1	Level 2	Level 3	Total Fair Value
Derivative assets	7	-	7	-	7
AFS financial assets					
Debt securities					
Government securities	6,344,394	2,981,567	3,362,827	-	6,344,394
Equity securities					
Unquoted	-	-	-	-	-
	6,344,401	2,981,567	3,362,834	-	6,344,401
Assets for which fair values are disclosed					
Loans and receivables	2,752,564	-	-	2,771,431	2,771,431
Other assets - refundable deposit and RCOCI	15,066	-	-	14,130	14,130
	2,767,630	-	-	2,785,561	2,785,561
	9,112,031	2,981,567	3,362,834	2,785,561	9,129,962
Liabilities measured at fair value					
Derivative liabilities	17	-	17	-	17

When fair values of listed equity and debt securities, as well as publicly traded derivatives at the reporting date are based on quoted market prices or binding dealer price quotations, without any deduction for transaction costs, the instruments are included within Level 1 of the hierarchy.

For all other financial instruments, fair value is determined using valuation techniques. Valuation techniques include net present value techniques, comparison to similar instruments for which market observable prices exist and other revaluation models.

Instruments included in Level 3 include those for which there is currently no active market.

In 2018 and 2017, there were no transfers between Level 1 and Level 2 fair value measurements, and no transfers into and out of Level 3 fair value measurements.

Estimated fair value of assets classified as Level 3 items is considered not material relative to the overall size of the Bank's assets and liabilities recorded at fair value.

Favorable and unfavorable changes are determined on the basis of sensitivity analysis. The fair value of AFS financial assets classified as Level 3 is not material and any changes in the fair value is not expected to have any significant impact to the valuation of financial assets taken as a whole.

CVA and DVA methodology

The Bank calculates the CVA by applying the PD of the counterparty, conditional on the non-default of the Bank, to the Bank's expected positive exposure (EPE) of the counterparty to the Bank and multiplying the result by the loss expected in the event of default. Both calculations are performed over the longest unbroken period.

The Bank uses a simulation methodology to calculate the EPE to a counterparty. This incorporates a range of potential exposures across the portfolio of transactions with the counterparty over the life of the portfolio. The simulation methodology considers effect of credit mitigants such as counterparty netting agreements and collateral agreements with the counterparty.

Calculation of DVA follows the same approach as the CVA described above.

As at December 31, 2018 and 2017, CVA/DVA of the Bank amounts to nil.

Funding fair value adjustment

The funding fair value adjustment (FFVA) is calculated by applying future market funding spreads to the expected future funding of any uncollateralised component of the OTC derivative portfolio. This includes the uncollateralised component of collateralised derivative contracts in addition to derivatives that are fully uncollateralised. The expected future funding exposure is calculated by a simulation methodology, where available. The expected future funding exposure is adjusted for events that may terminate the exposure such as the default of the Bank or the counterparty. The FFVA and DVA are calculated independently.

6.5 Capital risk management

Refer to Note 18.

7 Cash and cash equivalents

This account as at December 31 consists of:

	Note	2018	2017
Cash and other cash items		197,666	168,148
Due from Bangko Sentral ng Pilipinas	8	913,800	3,698,433
Due from other banks		1,337,086	1,848,574
Interbank loans receivable and securities purchased under resale agreement	8	631,877	417,919
		3,080,429	6,133,074

Cash and cash equivalents are classified as current.

Due from other banks maintained with other local and foreign banks in 2018 earns an average interest annual interest rate of 0.17% (2017 - 0.04%). Deposits maintained with intragroup banks in 2018 are non-interest bearing, except for Chinese Yuan deposits which earned an average annual interest of 1.07% (2017 - 0.18%).

8 Loans and advances to other banks

As at December 31, 2018, due from BSP consists of demand deposit accounts and placements in deposit facilities amounting to P914 million (2017 - P3,698 million).

The deposit facilities earn annual interest ranging from 2.50% to 4.25% in 2018 (2017 - 2.50% to 3.50%).

The demand deposit account with BSP is non-interest bearing.

The interbank loans receivables and SPURA account consists of:

	2018	2017
BSP	76,000	52,869
Other banks	555,877	365,050
	631,877	417,919

Interbank loans earn annual interest ranging from 0.70% to 5.25% in 2018 (2017 - 0.05% to 3.00%).

9 Derivative financial instruments

The Bank enters into interest rate swap and currency forwards to manage its foreign exchange and interest rate risks. Currency forwards are contractual agreements to buy or sell a specified currency at a specific price and date in the future. Interest rate swaps are contractual agreements to exchange interest and foreign exchange differentials based on specific notional amounts.

Gains and losses from changes in fair value of derivatives that do not qualify for hedge accounting and gains and losses on the hedged items are being reported immediately in profit or loss.

The table below shows information on outstanding derivatives of the Bank at December 31, along with their equivalent peso notional amounts and respective fair value:

	2018			2017		
	Notional Amounts	Positive Fair Value	Negative Fair Value	Notional Amounts	Positive Fair Value	Negative Fair Value
Forward exchange bought	-	-	-	57,750	-	-
Forward exchange sold	18,140	15	4	57,760	7	17
	18,140	15	4	115,510	7	17

The notional contract amounts of derivatives indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Hedging derivative instruments and hedged items

As at December 31, 2018 and 2017, the Bank has no derivative hedging instruments.

10 Financial assets at FVOCI and AFS financial assets

This account at December 31 consists of:

	2018	2017
Debt securities		
Government		
Non-hedged	7,906,317	6,344,394
Hedged	-	-
Equity securities - unquoted	-	-
	7,906,317	6,344,394

Unquoted equity securities represent long-term investments of the Bank which are not actively traded in the market.

As at December 31, 2018 and 2017, financial assets at FVOCI and AFS financial assets respectively, in the books of the Parent Company with face amount of P1.00 billion are earmarked in the Registry of Scripless Securities (RoSS) to secure the deposits in the form of nostros, clearing and settlement accounts of the Bank with the Parent Company.

The movements of net unrealised losses on financial assets at FVOCI and AFS financial assets as at December 31 follow:

	2018	2017
Balance at beginning of year	(11,803)	2,190
Impact of adoption of PFRS 9	616	-
Unrealised losses recognised in other comprehensive income	(56,184)	(13,733)
Realised losses taken to profit and loss	(34,494)	(260)
Balance at end of year	(101,865)	(11,803)
Tax effect (Note 23)	16,366	41
Balance at end of year - net of tax	(85,499)	(11,762)

Financial assets at FVOCI (2017 - AFS financial assets) earned nominal annual interests in 2018 ranging from 0.00% to 10.63% (2017 - 0.00% to 14.38%). Interest income for the year ended December 31, 2018 from financial assets at FVOCI (2017 - AFS financial assets) amounts to P213 million (2017 - P113 million).

In 2018 and 2017, there are no losses on the change in fair value of financial assets at FVOCI and AFS financial assets, respectively, attributable to the hedged risk.

11 Loans and receivables, net

This account at December 31 consists of:

	Note	2018	2017
Personal loans		2,429,536	2,686,599
Accrued interest receivable		78,829	70,504
Accounts receivable		1,558	8,961
		2,509,923	2,766,064
Less: Allowance for credit and impairment losses	14	19,465	13,500
		2,490,458	2,752,564

As at December 31, 2018, 96.09% (2017 - 95.31%) of the total loans of the Bank are subject to periodic interest repricing. Remaining loans earn annual fixed interests in 2018 ranging from 3.88% to 8.40% (2017 - 3.50% to 8.40%).

	2018	2017
Current	260,858	270,297
Non-current	2,249,065	2,495,767
	2,509,923	2,766,064

Loans and receivables classified as current are those which are expected to be realised within 12 months after reporting date while non-current balances pertain to those expected to be collected beyond 12 months after reporting date.

Details of the personal loans and receivables portfolio as to collateral at December 31 are as follows:

	2018	2017
Loans secured by:		
Deposit hold-out	93,903	124,373
Real estate	1,437,462	1,571,578
	1,531,365	1,695,951
Unsecured loans	898,171	990,648
	2,429,536	2,686,599

The Bank's restructured loans as at December 31, 2018 amount to P4.44 million (2017 - P4.92 million).

The following table shows the gross carrying amounts of the Bank's restructured loans by stages. Personal renegotiated loans are deemed to remain credit-impaired until repayment or derecognition.

	December 31, 2018	January 1, 2018
	Stage 3	Stage 3
Personal loans		
Gross carrying amount	4,441	4,921
Allowance for credit and impairment losses	(488)	(541)
	3,953	4,380

Information on the concentration of credit as to industry of loans and receivables is presented in Note 6 to the financial statements.

The Bank does not have loans and receivables used as security for bills payable.

12 Property and equipment, net

The account at December 31 consists of:

	2018			2017		
	Furniture, Fixtures and Equipment	Leasehold Improvements	Total	Furniture, Fixtures and Equipment	Leasehold Improvements	Total
Cost						
Balance at beginning of year	125,254	113,428	238,682	124,310	106,217	230,527
Additions	3,777	167	3,944	944	7,211	8,155
Disposals	-	-	-	-	-	-
Balance at end of year	129,031	113,595	242,626	125,254	113,428	238,682
Accumulated depreciation and amortisation						
Balance at beginning of year	123,398	100,413	223,811	122,405	97,245	219,650
Depreciation and amortisation	1,587	4,484	6,071	993	3,168	4,161
Disposals	-	-	-	-	-	-
Balance at end of year	124,985	104,897	229,882	123,398	100,413	223,811
Net Book Value	4,046	8,698	12,744	1,856	13,015	14,871

As at December 31, 2018, the total cost of fully depreciated furniture, fixtures and equipment amounts to P212.90 million (2017 - P211.35 million).

Depreciation is included in “Depreciation and amortisation” in the statement of income.

13 Other assets, net

This account at December 31 consists of:

	Note	2018	2017
Refundable deposits and RCOCI		17,255	15,066
Prepaid expenses		8,197	6,880
Retirement benefit asset	19	-	24,958
Sundry debits and others		52,904	36,493
		78,356	83,397

Sundry debits and others include assets held-for-sale, prepaid tax and ATM settlement suspense account.

14 Allowance for credit and impairment losses

Loans and receivables

Movements in allowance for credit and impairment losses for loans and receivables follow:

	2018	2017
Balance at beginning of year	13,500	15,965
Impact of PFRS 9 adoption (Note 3)	9,977	-
Credit and impairment losses	9,789	15,397
Accounts charged-off and others	(13,801)	(16,775)
Unwinding of interest	-	(1,087)
Balance at end of year	19,465	13,500

As at December 31, 2018 and 2017, allowance for credit and impairment losses pertains to collective and specific impairment on personal loans.

Loans and advances to banks and investment securities

Allowance for credit and impairment losses recognised for loans and advances to banks follows:

	Due from other banks	IBCL and SPURA	Financial assets at FVOCI	Total
Balance at beginning of year	-	-	-	-
Impact of PFRS 9 adoption (Note 3)	195	-	616	811
(Reversal of) credit and impairment losses	(145)	4	(119)	(260)
Balance at end of year	50	4	497	551

In 2018, there is no allowance for credit and impairment losses recognised for due from BSP.

The related allowance for credit and impairment losses for financial assets at FVOCI is presented within the "Net unrealised losses on financial assets at FVOCI, net of tax" in the statement of financial position, while the related credit and impairment losses are recognised within "Credit and impairment losses" in the statement of income.

15 Deposit liabilities

As at December 31, 2018, 15.22% (2017 - 18.27%) of the total deposit liabilities of the Bank were subjected to periodic interest repricing on the renewal date. Remaining peso-denominated deposit liabilities earn annual fixed interest rates ranging from 0.00% to 0.20% (2017 - 0.00% to 0.20%) in 2018 and foreign currency-denominated deposit liabilities earn annual fixed interest rates ranging from 0.00% to 0.01% in 2018 (2017 - 0.00% to 0.01%), depending on the type of currency.

Interest expense on deposit liabilities for the year ended December 31, 2018 amounts to P10.07 million (2017 - P11.53 million).

The required statutory reserves as reported to BSP in 2018 amounts to P465.81 million (2017 - P580.51 million).

16 Bills payable

As at December 31, 2018, bills payable represents foreign currency-denominated interbank borrowings from other foreign banks under common control amounting to P79.75 million (2017 - P30.30 million). Term borrowings are subject to annual fixed interest rates ranging from -0.70% to 2.42% (2017 - -0.08% to 1.92%).

Movements in the account are summarised below:

	2018	2017
Beginning	30,307	290,414
Additions	6,964,510	2,472,143
Payments	(6,914,958)	(2,701,853)
Exchange difference	(109)	(30,397)
	79,750	30,307

17 Accrued expenses and other liabilities

This account at December 31 consists of:

	2018	2017
Unclaimed balances	61,465	51,683
Accrued expenses	20,845	55,480
Taxes payable	9,026	6,267
Accounts payable	6,086	8,793
Retirement liability	2,254	-
Accrued interest	1,446	554
Sundry credits and others	7,921	9,272
	109,043	132,049

As at December 31, 2018, accrued expenses include accrued fees to Philippine Deposit Insurance Corporation amounting to P11.77 million (2017 - P13.67 million).

Sundry credits and others include suspense and unposted accounts.

18 Equity

As at December 31, 2018 and 2017, the details of the Bank's common shares with par value per share of P10.00 are as follows:

	Shares	Amount
Authorised common shares	200,000,000	2,000,000
Issued and outstanding common shares	149,200,000	1,492,000

On September 6, 2018, the BOD of the Bank approved the declaration of cash dividends amounting to P115 million or P0.77 per share. This amount was paid in full in 2018.

On October 24, 2017, the BOD of the Bank approved the declaration of cash dividends amounting to P226 million or P1.51 per share. This amount was paid in full in 2017.

In compliance with the requirement in BSP Circular 1011, the Bank is required to appropriate its retained earnings account for the difference between the General Loan Loss Provision (GLLP) and its allowance for credit and impairment losses for loans and receivables. Following this requirement, the Bank's BOD approved the appropriation of Retained Earnings amounting to P20.75 million effective as at December 31, 2018.

Capital Management

The Bank's objective for managing capital is to maintain appropriate levels of capital to support business strategy and to meet regulatory and stress testing related requirements.

The Bank's approach to capital management is driven by strategic and organisational requirements, taking into account the regulatory, economic and commercial environment in which the Parent, and its fellow subsidiaries operate. Pre-tax return on risk-weighted assets ('RoRWA') is an operational metric by which the global businesses are managed on a day-to-day basis. The metric is calibrated against return on equity and Bank's capital requirements to ensure that the Bank is best placed to achieve capital strength and business profitability, combined with regulatory capital efficiency objectives. It is the Bank's objective to maintain a strong capital base to support the risks inherent in the business and invest in accordance with the strategy, exceeding both consolidated and local regulatory capital requirements at all times.

The Bank's policy on capital management is underpinned by a capital management framework and internal capital adequacy assessment process, which enables us to manage our capital in a consistent manner. The framework, which is approved by the Global Management Board (GMB) annually, incorporates a number of different capital measures including market capitalisation, shareholders' equity, economic capital and regulatory capital.

The determination of compliance with regulatory requirements and ratios is based on the amount of the Bank's unimpaired capital (regulatory net worth) as reported to the BSP, which is determined on the basis of regulatory accounting practices which differ from PFRSs in some respects.

BASEL III

Under the existing BSP regulations, the capital accounts of the Bank should not be less than an amount equal to ten percent (10.00%) of its risk-weighted assets. Risk assets are defined as total assets less cash on hand, due from BSP, loans covered by hold-out on or assignment of deposits, loans or acceptances under letter of credit to the extent covered by margin deposits and other non-risk items as determined by the MB of the BSP.

The capital-to-risk assets ratios (CAR) of the Bank as reported to the BSP as at December 31 are shown in the table below:

	2018	2017
Tier 1 Capital	1,345	1,441
Tier 2 Capital	30	32
Total Qualifying Capital	1,375	1,473
Risk-weighted Assets	4,145	4,663
Tier 1 Capital Ratio	32.44%	30.89%
Total Capital Ratio	33.15%	31.59%

The regulatory qualifying capital of the Bank consists of Tier 1 (core) and Tier 2 (supplementary) capital. Tier 1 capital is mainly comprised of paid-up share capital, retained earnings, current year's profit, and other comprehensive income. Tier 2 capital is composed of general loan loss provision limited to 1% of credit risk-weighted assets. Regulatory adjustments, as indicated in BSP Circular 781, are applied to Tier 1 and Tier 2 capital.

As at December 31, 2018 and 2017, the Bank complied with all of the externally imposed capital requirements by the BSP. Based on CAR reports submitted by the Bank to the BSP as at

December 31, 2018, the reported adjusted qualifying capital of P1.37 billion (2017 - P1.47 billion), exceeded the required minimum regulatory capital of P0.75 billion for the Bank.

Based on the CAR reports submitted to BSP, the Bank's CAR in 2018 of 33.15% (2017 - 31.59%), exceeded the minimum 10.00% requirement.

The BSP decided to subject foreign bank branches to the 'Internal Capital Adequacy Assessment Process' (ICAAP) process to learn how a branch assesses its capital in relation to its business plans and operations in the Philippines. The Parent Company has submitted its latest ICAAP document to the BSP last March 29, 2019 in compliance with BSP Circular 731 dated July 28, 2011.

19 Employee benefits

Retirement Plans

The Bank is covered by a funded, non-contributory defined benefit (DB) plan and a defined contribution (DC) plan.

Under the retirement plan, all covered officers and employees are entitled to cash benefits after satisfying certain age and service requirements. The latest actuarial valuation study of the retirement plan was as at December 31, 2018.

Employees of the Bank hired prior to July 1, 2007 are initially covered under the DB plan while employees hired after July 1, 2007 are covered under the DC plan. Employees covered under the DB plan have an option for a hybrid plan where they can be covered under both retirement plans. There are no new members to the DB plan subsequent to the said date.

The DB and the DC plan were approved by the Bureau of Internal Revenue (BIR) as tax-exempt plans under RA No. 4917 and Revenue Regulations (RR) Nos. 1-68 and 1-83.

In 2016, the retirement fund is being managed and administered by the Parent Company's Trust Department which is covered by a Trust Agreement. Effective April 3, 2017, the Trust Department resigned as the co-trustee of the fund. Following the resignation, the DB Plan changed its co-trustee to BPI Asset Management and Trust Corporation (BPI AMTC). Concurrently, the DC Plan changed its co-trustee to BDO Unibank, Inc. - Trust and Investments Group (BDO TIG) and its Fund Manager to BDO TIG from BPI AMTC.

Defined Benefit Retirement Plan

The annual contributions of the Bank to the DB plan consists of a payment covering the current service cost and interest on such unfunded actuarial liability.

The principal actuarial assumptions used in determining retirement liability of the Bank as at December 31 are shown below:

	2018	2017
Retirement age (in years)	60	60
Average remaining working life (in years)	11	14
Discount rate	5.90%	4.80%
Future salary increases	3.50%	3.50%

The component of net retirement benefit asset accrued for the year recognised in the statement of income under “Compensation and personnel-related costs” and statement of total comprehensive income under “Remeasurement losses on retirement plan” follow:

	2018	2017
Components of net retirement benefit asset recorded in profit or loss		
Current service cost	4,574	4,380
Adjustment to service cost	-	-
Net interest expense		
Interest expense	4,400	3,300
Interest income	(5,958)	(3,716)
	3,016	3,964
Components of net retirement benefit asset recorded in OCI		
Remeasurement losses (gains) on obligation arising from:		
Change in financial assumptions	(484)	(10,274)
Experience adjustment	12,201	(5,858)
Remeasurement losses (gains) on plan assets	11,228	(1,943)
	22,945	(18,075)
Total components of net retirement benefit asset recognised during the year	25,961	(14,111)

The movements in remeasurement losses in equity at December 31 follow:

	Note	2018	2017
Balance at beginning of year		62,292	80,367
Remeasurement losses (gains) on obligation arising from:			
Change in financial assumptions		(484)	(10,274)
Experience adjustment		12,201	(5,858)
Remeasurement losses (gains) on plan assets		11,228	(1,943)
		22,945	(18,075)
Total remeasurement losses before tax effect		85,237	62,292
Tax effect	23	(25,571)	(18,688)
		59,666	43,604

The net retirement benefit asset recognised in the Bank’s statement of financial position follows:

	Notes	2018	2017
Present value of defined benefit obligation		97,169	75,500
Fair value of plan assets		(94,915)	(100,458)
Net retirement liability (asset)	17, 13	2,254	(24,958)

The movements in the present value of the defined benefit obligation follow:

	2018	2017
Balance at beginning of year	75,500	69,454
Current service cost	4,574	4,380
Adjustment to service cost	-	-
Interest expense	4,400	3,300
Benefits paid	-	-
Transfer payments	978	14,498
Remeasurement losses (gains) on obligation arising from:		
Change in financial assumptions	(484)	(10,274)
Experience adjustment	12,201	(5,858)
Balance at end of year	97,169	75,500

The movements in the fair value of plan assets recognised follow:

	2018	2017
Balance at beginning of year	100,458	76,337
Interest income	5,958	3,716
Contribution paid by employers	3,016	3,964
Benefits paid	-	-
Transfer payments	(3,289)	14,498
Remeasurement (losses) gains on plan assets	(11,228)	1,943
Balance at end of year	94,915	100,458

The assets of the plan across all entities covered by the multi-employer benefit plan based on the year-end defined benefit obligation. Consequently, a one-time notional asset transfer out amounting to P3.29 million was reflected in order to align the return on assets per entity.

The actual return on plan assets of the Bank in 2018 amounts to P5.27 million loss (2017 - P5.66 million gain).

The Bank expects to contribute P4.38 million to its DB plan in 2019.

The major categories of plan assets as a percentage of the fair value of total plan assets follow:

	2018		2017	
	Amount	%	Amount	%
Equity instruments	17,975	18.94%	65,247	64.95%
Debt instruments				
Government	15,033	15.84%	8,981	8.94%
Corporate	22,264	23.46%	19,670	19.58%
UITF	5,651	5.95%	11,362	11.31%
Other assets, net	33,992	35.81%	(4,802)	(4.78%)
	94,915	100.00%	100,458	100.00%

Other assets include deposits, receivables and payables.

The asset allocation of the DB Plan is set and reviewed from time to time by the plan trustees taking into account the membership profile, the liquidity requirements of the DB Plan and risk appetite of the plan sponsor. This also considers the expected benefit cash flows to be matched with asset durations.

Contributions are agreed between the plan trustees and the Bank, in consideration of the contribution advice from the plan actuary. The defined benefit plan typically exposes the Bank to a number of risks such as investment risk, interest rate risk and salary risk. The most significant of which relate to investment and interest rate risk.

The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using 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 liability. A decrease in government bond yields will increase the defined benefit obligation although this will also be partially offset by an increase in the value of the plan's fixed income holdings. Hence, the present value of defined benefit obligation is directly affected by the discount rate to be applied by the Bank. However, the Bank believes that due to the long-term nature of the pension liability and the strength of the Bank itself, the mix of debt and equity securities holdings of the plan is an appropriate element of the Bank's long term strategy to manage the plan efficiently.

Sensitivity analysis

Reasonably possible changes at the reporting date to one of the relevant actuarial assumptions, with all other assumptions constant, would have affected the net retirement liability of the Bank as follows:

	Discount Rate		Salary Increase Rate	
	0.50%	-0.50%	0.50%	-0.50%
(Decrease) increase in DBO	(0.06%)	0.08%	0.09%	(0.06%)

Although the analysis does not take into account of the full distribution of cash flows expected under the plan, it does provide an approximation of the sensitivity of the assumption shown.

As at December 31, 2018 and 2017, the undiscounted expected future benefit payments for retiring employees covered by the defined benefit plan are presented below:

	2018	2017
Within one year	1,903	1,843
Over one year but not more than five years	11,950	9,758
Over five years	278,004	27,191

The weighted average duration of the defined benefit obligation in 2018 is 10.87 years (2017 - 13.62 years).

Defined contribution retirement plan

The contributions of the Bank to the defined contribution plan are made monthly and are based on the employee's monthly basic salary as follows (%):

Voluntary Employee	Basic	Matching	Total	Total (Employee and Bank)
0.0	12.0	0.0	12.0	12.0
1.0	12.0	1.0	13.0	14.0
2.0	12.0	2.0	14.0	16.0
3.0	12.0	3.0	15.0	18.0
4.0	12.0	4.0	16.0	20.0
5.0	12.0	5.0	17.0	22.0

Total contributions made to the DC Plan for the years ended December 31 are summarised as follows:

	2018			2017		
	Conservative	Moderate	Total	Conservative	Moderate	Total
Employee-member contributions	194	443	637	228	452	680

Defined contribution retirement plan subject to requirements of RA 7641

As discussed in Note 5.11, the Bank maintains a DC plan which is accounted for as a defined benefit plan with minimum guarantee.

The reconciliation of the retirement benefit asset determined using the projected unit credit method are as follows:

	2018	2017
Fair value of plan assets	32,385	37,055
Present value of defined benefit obligation	(13,640)	(15,294)
Surplus	18,745	21,761

Retirement benefit asset is not recognised in the statement of financial position. The excess of fair value of plan assets over the present value of defined benefit obligation represents forfeitures of contributions made for employees who eventually resigned.

The movements in the present value of the defined contribution obligation are as follows:

	2018	2017
Balance at beginning of year	15,294	21,463
Current service cost	1,750	2,050
Interest expense	846	832
Benefits paid	(4,885)	(8,036)
Transfer payments	949	(1,100)
Remeasurement (gains) losses on obligation arising from experience adjustment	(314)	85
Balance at end of year	13,640	15,294

The movements in the fair value of plan assets follow:

	2018	2017
Balance at beginning of year	37,055	40,011
Interest income	2,144	1,995
Contribution paid by employer	503	3,006
Benefits paid	(4,885)	(8,036)
Transfer payments	949	(1,100)
Remeasurement (losses) gains on plan assets	(3,381)	1,179
Balance at end of year	32,385	37,055

The Bank does not recognise any retirement liability from the DC plan as the fair value of the defined contributions exceeded the minimum defined benefit guaranteed under RA No. 7641.

The amounts of net retirement benefit asset that would have been recognised in the statement of income under "Compensation and personnel-related cost" and statement of total comprehensive income under "Remeasurement losses on retirement plan" follow:

	2018	2017
Components of net retirement benefit (asset) liability recorded in profit or loss		
Current service cost	1,750	2,050
Net interest expense		
Interest expense	846	832
Interest income	(2,144)	(1,995)
	452	887
Components of net retirement benefit asset that would have been recorded in OCI		
Remeasurement (gains) losses on defined benefit obligation	(314)	85
Remeasurement losses (gains) on plan assets	3,381	(1,179)
	3,067	(1,094)
Total components of net retirement benefit asset that would have been recognised during the year	3,519	(207)

The major categories of plan assets as a percentage of the fair value of total plan assets follow:

	2018	2017
Debt instruments	77.50%	90.73%
Equity instruments	6.77%	6.92%
Other assets	15.73%	2.35%
	100.00%	100.00%

The asset allocation of the DC Plan is set and reviewed from time to time by the DC Plan trustees taking into account the membership profile, the liquidity requirements of the DC Plan and risk appetite of the DC Plan sponsor.

Contributions are determined based on the plan provisions.

The expected contribution for the year ending December 31, 2018 of the Bank amounts to P2.09 million.

As at December 31, 2018 and 2017, the undiscounted expected future benefit payments for retiring employees covered by the defined contribution plan are presented below:

	2018	2017
Within one year	3,638	380
Over one year but not more than five years	1,934	2,729
Over five years	4,214	5,823

The weighted average duration of the defined benefit obligation as at December 31, 2018 is 12.37 years (2017 - 12.56 years).

The following table shows principal actuarial assumptions used in determining retirement liability of the Bank as at December 31, 2018 and 2017 are shown below:

	2018	2017
Discount rate	7.40%	5.60%
Future salary increases	3.50%	3.50%

Changes in the assumptions above are not expected to significantly impact the defined benefit obligation of the Bank.

The Bank has no transactions with the retirement fund aside from contributions paid and usage of forfeitures.

20 Share-based payments

The Bank operates savings-related share option schemes which are settled by delivery of shares of the Ultimate Parent Company.

Savings-related share option schemes are accounted as an equity-settled share-based transaction.

HSBC share option plans

Award	Policy	Purpose
Savings-related share option plans	• The last grant of options under the International Plan was in 2012. • Eligible employees save up to GBP250 per month, with the option to use the savings to acquire shares. • Exercisable within six (6) months following either the third or fifth anniversaries of the commencement of three-year or five-year contracts, respectively, (or for options granted prior to 2013, three months following the first anniversary of the commencement of a one-year savings contract). • The exercise price is set at a 20.00% discount to the market value immediately preceding the date of invitation.	• To align the interests of all employees with the creation of shareholder value.

There are no outstanding stock options as at December 31, 2018 and 2017.

The amount of reversal of expenses related to share-based payments for the year ended December 31, 2018 included under "Compensation and personnel-related costs" in the statement of income is nil (2017 - P15 thousand).

The amount relating to share option and share awards granted to employees of the Bank directly by the Ultimate Parent Company is reported under "Other reserves" in the statement of financial position is nil (2017 - P10.92 million).

21 Lease contracts

The Bank leases the office premises it occupies. The contracts on these leases range from 1 to 5 years and are renewable upon mutual agreement of the parties. Various lease contracts include escalation clauses, most of which bear an annual rent increase of 3.00% to 10.00%. As at December 31, 2018 and 2017, the Bank had no contingent rent payable. Rental expenses of the Bank in 2018 amounting to P28.19 million (2017 - P25.63 million) is included under "Occupancy and equipment - related costs" amount in the statement of income.

The future minimum rentals payable under non-cancellable operating leases are as follows:

	2018	2017
Within one year	16,592	24,144
Beyond one year but within five years	11,847	32,069
	28,439	56,213

22 Income and expenses

Fees and commission income for the years ended December 31 relates to the following:

	2018	2017
Account administration	18,260	20,076
Remittance	5,898	7,847
Intra-group transactions	4,458	6,387
Collection bills	12	91
Others	5,980	8,972
	34,608	43,373

Other fees and commission income includes handling fees, service charges and sundry charges.

Other operating income includes recoveries from previously written-off accounts amounting to P3.82 million in 2018 (2017 - P2.30 million).

Other operating expenses for the years ended December 31 consist of:

	2018	2017
Insurance	24,780	28,214
Outside services	16,938	18,809
Transportation	2,239	2,514
Professional fees	1,842	2,918
Communication	1,414	2,399
Stationeries and supplies	1,012	966
Others	27,958	55,240
	76,183	111,060

Other expenses include payments made to the Parent Company generally for management fees amounting to P53.48 million (2017 - P53.48 million) (Note 26). In 2018, there was a reversal in other expenses amounting to P23.13 million for the amount of penalty charges related to uncertain tax provision.

23 Income and other taxes

Income tax expense for the year ended December 31 consists of:

	2018	2017
Current		
Final	40,125	50,597
RCIT - Current Year	-	-
MCIT	3,549	4,485
	43,674	55,082
Deferred	(4,054)	905
	39,620	55,987

The reconciliation between the statutory income tax and the effective income tax rates follows:

	2018	2017
Statutory income tax rate	30.00%	30.00%
Tax effect of:		
Other non-deductible expenses	8.95%	18.86%
Tax-paid and tax-exempt income	(11.73%)	(13.39%)
FCDU income before income tax	(4.26%)	(2.13%)
Effective income tax rate	22.96%	33.34%

In accordance with existing tax regulations, expenses specifically identified to the RBU or FCDU are reported and declared as expenses of the particular unit. Common operating expenses that cannot be specifically identified for a particular unit are allocated to the RBU and the FCDU based on the percentage share of gross income of the RBU and the FCDU to the total gross income of the entity.

The components of the net deferred tax assets follow:

	2018	2017
Deferred tax charged to statement of income		
Deferred tax asset on:		
Allowance for credit and impairment losses	5,957	4,040
Provision for administrative expenses	2,223	1,811
Unamortised past service cost	11,855	7,954
Lease provision	456	204
NOLCO	-	-
	20,491	14,009
Deferred tax liability on:		
Capitalised transaction costs	(2,076)	(2,881)
Deferred tax charged to OCI		
Remeasurement losses taken to equity	25,571	18,688
Net unrealised losses on financial assets at FVOCI	16,366	N/A
Net unrealised losses on AFS financial assets	N/A	41
	41,937	18,729
Net deferred tax assets	60,352	29,857

As at December 31, 2018, the Bank has available NOLCO amounting to P132.40 million (2017 - P92.96 million) and MCIT of P14.40 million (2017 - P14.07 million) both expiring in 2019 to 2021 (2017 - 2018 to 2020) for which no deferred tax asset was recognised.

24 Basic quantitative indicators of financial performance

The following basic ratios measure the financial performance of the Bank:

	2018	2017
Return on average equity	8.39%	6.20%
Return on average assets	0.94%	0.69%
Net interest margin over average earning assets	3.43%	3.16%

25 Commitments and contingent liabilities

In the normal course of business, the Bank enters into various commitments and incurs contingent liabilities that are not reflected in the accompanying financial statements. The Bank does not anticipate any material losses as a result of these transactions.

The Bank has pending claims and/or is a defendant in legal actions arising from normal business activities. Management and its legal counsel believe that these actions are without merit or that the ultimate liability, if any, resulting from such actions will not materially affect the Bank's financial statements.

Regulatory Reporting

Commitments and contingencies at their equivalent peso contractual amounts with off-balance sheet risks as at December 31 pertain to undrawn loan commitments amounting to P14.95 million (2017 - P55.10 million).

26 Related party transactions

In the ordinary course of business, the Bank has loan transactions with the Parent Company, other branches and group offices, and with certain DOSRI. Under the existing policies of the Bank, these loan transactions are made substantially on the same terms and conditions as loan transactions with individuals and businesses of comparable risks.

Details of DOSRI loans:

	2018	2017
Total outstanding DOSRI loans	23,799	25,620
New DOSRI loans granted under BSP Circular No. 423	23,799	25,620
Percent of DOSRI loans to total loans	0.95%	0.94%
Percent of unsecured DOSRI loans to total DOSRI loans	42.60%	52.10%
Percent of past due DOSRI	Nil	Nil
Percent of non-performing DOSRI	Nil	Nil

DOSRI loans represent loans extended to officers and employees of the Bank approved by the BSP.

The Bank and its Parent Company have an existing agreement wherein the latter provides support services which include human resources, internal audit, finance and accounting, general services and operations, and credit services for a certain amount. The agreement shall continue to be effective unless terminated by either party through a written notice of either party at least sixty (60) days prior to the intended date of termination. Expenses related to this agreement amounted to P119 million (P65.52 million under "Occupancy and equipment - related costs" and P53.48 million under "Share in Head Office expenses") in 2018 and to P129.51 million (P76.03 million under "Occupancy and equipment - related costs" and P53.48 million under "Share in Head Office expenses") in 2017.

For the year ended December 31, 2018, transactions with the Parent Company, entities under common control and other related parties include outright purchases of securities totalling to P12.62 billion (2017 - P5.24 billion).

The account balances with respect to related parties included in the financial statement of the Bank including contingent accounts follow:

	2018		2017		
	Transaction Volume*	Outstanding Balances	Transaction Volume*	Outstanding Balances	Terms & Conditions
Intercompany Nostro					
Parent Company	30,775,638	260,084	24,672,424	339,553	Balances due to/from another HSBC Group reporting entity where both parties are banks. Nostro balances are (normally) in a foreign currency to the HSBC Group reporting entity's local currency and are the HSBC Group reporting entity's balance with the other party. These bear interest which ranges from 0.00% to 3.80%.
Head office and other branches	2,480,652	42,969	1,657,585	117,352	
Entities under common control	767,149	120,825	1,466,524	134,426	
	34,023,439	423,878	27,796,533	591,331	
Interbank Loans and Receivables					
Head office and other branches	139,339,011	555,881	46,224,264	365,050	These are short-term loans in various currencies with interest rates ranging from 0.10% to 2.60% and are collectible in cash.
Deposit Liabilities					
Parent Company	10,876,109	20,935	13,380,328	25,820	These are demand deposits which are non-interest bearing and are payable in cash.
Head office and other branches	-	-	-	-	
Entities under common control	73,395,431	80,201	83,494,820	174,052	These are interest-bearing deposits with rates ranging from 0.00% to 0.10% for both 2018 and 2017, and are payable in cash.
	84,271,540	101,136	96,875,148	199,872	

(forward)

	2018		2017		
	Transaction Volume*	Outstanding Balances	Transaction Volume*	Outstanding Balances	Terms & Conditions
Financial Liabilities at FVTPL					Derivative financial liabilities represent the gross negative fair value of all foreign exchange, interest rate, and other derivative contracts, after applying netting that is allowable under PFRS.
Parent Company	-	-	-	-	
Bills Payable					
Head office and other branches	6,895,865	79,750	6,936,777	30,307	Bills payable have short term maturities and are payable in cash. These are subject to interest with rates ranging from 0.00% to 4.24% for both 2018 and 2017.
Accrued interest payable					
Parent Company	1	-	-	-	Accrued interest refers to interest incurred but not yet paid on Bills payable.
Head office and other branches	2,136	26	1,453	4	
Entities under common control	345	-	413	-	
	2,482	26	1,866	4	

**Aggregate transaction amounts were taken up to represent volume for the year.*

The outstanding balances with related parties are settled on demand at gross amounts, unless otherwise stated. There are no guarantees provided or collaterals held or pledged arising from these balances.

The aggregate amounts included in the determination of income before income tax that resulted from transactions with each class of related parties for the years ended December 31 are as follows:

	2018	2017
Interest income		
Parent Company	-	-
Head office and other branches	6,039	1,308
Entities under common control	-	-
	6,039	1,308
Interest expense		
Head office and other branches	1,022	251
Entities under common control	16	41
	1,038	292
Fee income		
Parent Company	1,118	3,607
Head office and other branches	3,215	2,618
	4,333	6,225
Fee expense		
Parent Company	-	-
Head office and other branches	277	224
Entities under common control	2,357	3,089
	2,634	3,313
Operating expenses		
Parent Company	119,005	129,516

Interest and fees are earned from and charged on the related parties due to interbank nostro/vostro fund transfers.

Contingent accounts on forwards and swaps are in notional amounts.

	2018	2017
Forward Exchange Bought		
Parent Company	-	-
Head Office and Other Branches	18,140	20,802
Forward Exchange Sold		
Parent Company	-	-
Head Office and Other Branches	70,709	20,799
Interest Rate Swap Agreements		
Parent Company	-	-

The remuneration of key management included under “Compensation and personnel-related costs” in the statement of income follows:

	2018	2017
Short-term employee benefits	30,252	32,689
Share-based payments	-	67
Post-employment benefits	158	-
	30,410	32,756

Directors’ fees paid to non-executive directors of the Bank in 2018 is P1.03 million (2017 - P1.25 million).

Deposit liabilities of the Bank from its key management personnel largely pertain to compensation-related accounts.

27 Supplementary information required by the Bureau of Internal Revenue

Below is the additional information required by Revenue Regulations No. 15-2010 that is relevant to the Bank. This information is presented for purposes of filing with the BIR and is not required part of the basic financial statements.

(i) Gross Receipts Tax (GRT)

The Bank is subject to GRT on its gross income from Philippine sources. GRT is imposed on interest, fees and commissions from lending activities at 5.00% or 1.00%, depending on the loan term, and at 7.00% on non-lending fees and commissions, net trading and foreign exchange gains and other items constituting gross income.

In the FCDU, income classified under "All Others" is subject to corporate income tax and to GRT.

Details of the Bank's GRT expense and corresponding GRT tax base in 2018 are as follows:

	GRT Expense	GRT Tax Base
Interest income	18,885	412,498
Other income	4,655	67,597
	23,540	480,095

The above GRT is reported and paid in accordance with existing regulations of the BIR. GRT is included under "Taxes and licenses" in the statement of income.

(ii) Other Taxes and Licenses

In 2018, other taxes and licenses of the Bank consist of:

	Amount
Documentary stamps tax	15,188
Fringe benefit tax	3,454
Mayor's permit and other local taxes	1,933
	20,575

Other taxes and licenses above are reported and paid in accordance with existing regulations and are included under "Taxes and licenses" in the statement of income.

(iii) Withholding Taxes

Details of total remittances and withholding taxes payable as at December 31, 2018 follow:

	Total remittances	Withholding taxes payable
Withholding taxes on compensation and benefits	13,835	1,127
Expanded withholding taxes	10,498	1,445
Final withholding taxes	1,302	298
	25,635	2,870

Total remittances pertain to tax payments made for the reporting period covering January 2018 to November 2018. The outstanding withholding tax payable as at December 31, 2018 represents the withholding taxes for the month of December 2018 which were remitted in January 2018.

(iv) Tax Assessment

The Bank has pending 2011 tax assessment for alleged deficiency income tax in relation to RR No. 4 - 2011. The Bank joined a consortium of banks in legal action with the Makati Regional Trial Court which nullified RR4-2011 and made permanent the Injunction prohibiting the BIR from ruling or deciding on any administrative matter in relation to RR 4-2011. The case is pending with the Supreme Court as at December 31, 2018.