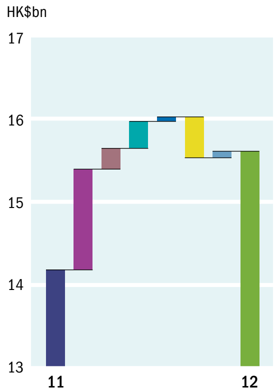
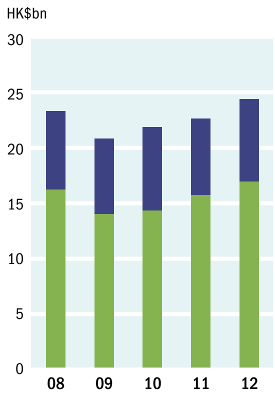
Financial Review

Operating Profit Analysis



	HK$m
2011 Operating profit	**14,181**
Changes due to:	
Net interest income	1,210
Net fee income	250
Other operating income	324
Loan impairment charges	54
Operating expenses	(491)
Impairment loss on intangible assets	78
2012 Operating profit	**15,606**

Net Operating Income
(Before loan impairment charges)



Net operating income
Non-interest income
Net interest income

Financial Performance

Income Statement

Summary of Financial Performance

Figures in HK$m	2012	2011 (restated)
Total operating income	**36,616**	34,207
Operating expenses	**8,389**	7,898
Operating profit after loan impairment charges	**15,606**	14,181
Profit before tax	**22,113**	19,255
Profit attributable to shareholders	**19,426**	16,885
Earnings per share (in HK$)	**10.16**	8.83

Hang Seng Bank Limited ("the Bank") and its subsidiaries ("the Group") reported a profit attributable to shareholders of HK$19,426m for 2012, up 15.0% compared with 2011. Earnings per share were up by 15.1% to HK$10.16. Profit attributable to shareholders for the second half of 2012 increased by HK$822m, or 8.8%, compared with the first half.

Operating profit excluding loan impairment charges grew by HK$1,371m, or 9.4%, to HK$15,992m.

This was underpinned by asset and deposit growth, increases in both net interest income and non-interest income, partly offset by the rise in operating expenses.

Net interest income rose by HK$1,210m, or 7.7%, driven by the 3.5% increase in average interest-earning assets and an improvement in the net interest margin.

The increase in interest-earning assets reflected the Bank's continued efforts to strengthen its asset and liability management and maintain a balanced growth strategy to expand its average loans and deposits.

Net interest margin rose by seven basis points to 1.85% and net interest spread increased by five basis points to 1.73%. Liability spreads have improved reflecting the increased value of core funding while asset spreads have narrowed as a result of the increase in cost of funds. The offshore renminbi business yield was higher through improved renminbi fund deployment from the low-yielding local clearing bank and fiduciary account to renminbi commercial lending and other financial instruments in light of the developments of the renminbi business in Hong Kong and the availability of a greater variety of renminbi denominated liquid assets. The Group continued to grow and manage its life insurance investment funds portfolio and grew its interest income by 8.9% compared with last year. However, Treasury balance sheet management income was negatively affected as the yield curve continued to flatten under the prolonged low interest rate environment. The contribution from net free funds was two basis points higher, at 0.12%.

Figures in HK$m	2012	2011
Net interest income/(expense) arising from:		
– financial assets and liabilities that are not at fair value through profit and loss	**18,162**	16,525
– trading assets and liabilities	**(1,268)**	(848)
– financial instruments designated at fair value	**52**	59
	16,946	15,736
Average interest-earning assets	**917,236**	886,156
Net interest spread	**1.73%**	1.68%
Net interest margin	**1.85%**	1.78%

Net interest income in the second half of 2012 grew by HK$374m, or 4.5%, compared with the first half, due mainly to a 4.1% increase in average interest earning assets and more days in the second half.

The HSBC Group reports interest income and interest expense arising from financial assets and financial liabilities held for trading as "Net trading income". Income arising from financial instruments designated at fair value through profit and loss is reported as "Net income from financial instruments designated at fair value" (other than for debt securities in issue and subordinated liabilities, together with derivatives managed in conjunction with them).

The table below presents the net interest income of Hang Seng, as included within the HSBC Group accounts:

Figures in HK$m	2012	2011
– Net interest income and expense reported as "Net interest income"		
Interest income	21,537	19,535
Interest expense	(3,375)	(3,010)
Net interest income	18,162	16,525
– Net interest income and expense reported as "Net trading income"	(1,268)	(848)
– Net interest income and expense reported as "Net income from financial instruments designated at fair value"	52	59
Average interest-earning assets	865,876	840,064
Net interest spread	2.00%	1.89%
Net interest margin	2.10%	1.97%

Net fee income increased by HK$250m, or 5.2%, to HK$5,086m compared with 2011.

With the increased demand for wealth management products, the Bank continued to launch new retail investment funds to meet different investor risk appetites and the growing demand for renminbi wealth management products, and saw income from retail investment funds increase by 24.9%.

Insurance-related fee income rose by 51.7%, benefiting from the increase in non-life insurance products distribution commission in the second half of the year as a result of the disposal of the general insurance manufacturing business to a third party insurance service provider. This increase was offset by a corresponding fall in non-life insurance underwriting profit in the second half of the year.

The Bank's effective marketing campaigns saw fee income from the credit card business grow by 11.3%, driven by the increase of 11.1% in cardholder spending and 5.4% in the number of cards in circulation. Credit facilities fee income rose significantly by 40.7%, due mainly to higher fees from increased corporate lending.

Fees from remittances and trade-related service income increased by 10.3% and 18.0% respectively as the Bank successfully captured opportunities from the increased trade activities and the expansion of renminbi cross-border trade settlement volumes.

However, these increases were offset by a 26.8% reduction in stockbroking and related services income, reflecting lower stock market turnover in the difficult market condition.

Compared with the first half of 2012, net fee income in the second half increased by HK$270m, or 11.2%, due mainly to the increases in income from the sales of retail investment funds, card, trade and insurance-related services.

Trading income rose by HK$267m, or 14.9%, to HK$2,063m.

Foreign exchange income rose by HK$143m, or 7.8%, driven by increased customer activity and higher demand for foreign exchange-linked structured products, notably in renminbi products, as well as the increase in net income from funding swaps*. These were partly offset by lower demand for renminbi denominated derivatives products linked with trade financing and reduced position taking for balance sheet management.

Income from securities, derivatives and other trading activities recorded net income of HK$77m compared with a net loss of HK$47m last year. This was primarily due to higher gains on equity options backing a life endowment product, which benefited from a favourable movement in the underlying equity indices, which was offset by a corresponding increase in "net insurance claims incurred and movement in policyholder liabilities". The unfavourable market interest rate movement also impacted the interest rate derivatives and debt securities trading income. Income from the sale of equity-linked structured products also registered lower income when compared with last year.

* Treasury from time to time employs foreign exchange swaps for its funding activities, which in essence involve swapping a currency ("original currency") into another currency ("swap currency") at the spot exchange rate for short-term placement and simultaneously entering into a forward exchange contract to convert the funds back to the original currency on maturity of the placement. In accordance with HKAS 39, the exchange difference of the spot and forward contracts is required to be recognised as a foreign exchange gain/loss, while the corresponding interest differential between the original and swap funding is reflected in net interest income.

Net income from financial instruments designated at fair value recorded a revaluation gain of HK$376m, compared with a revaluation loss of HK$160m in 2011.

This was mainly due to the fair value changes of assets held by the life insurance business, as a result of favourable equity market conditions. To the extent that this fair value gain was attributed to policyholders of unit-linked life insurance policies, there was a corresponding increase in "net insurance claims incurred and movement in policyholders' liabilities".

Net earned insurance premiums fell by HK$114m, or 1.0%. Net insurance claims incurred and movement in policyholders' liabilities rose by HK$625m, or 5.4%.

Analysis of income from wealth management business

Figures in HK$m	2012	2011 (restated)
Investment income:		
– retail investment funds	1,130	905
– structured investment products*	952	940
– private banking service fee**	123	173
– stockbroking and related services	941	1,285
– margin trading and others	142	134
	3,288	3,437
Insurance income:		
– life insurance	3,016	2,018
– general insurance and others	310	364
	3,326	2,382
Total	6,614	5,819

* Income from structured investment products includes income reported under net fee income on the sales of third-party structured investment products. It also includes profits generated from the selling of structured investment products in issue, reported under trading income.

** Income from private banking includes income reported under net fee income on investment services and profits generated from the selling of structured investment products in issue, reported under trading income.

The Bank continued to grow wealth management income, recording a rise of 13.7% to HK$6,614m when compared with 2011.

Investment income decreased by 4.3%, with income from stockbroking and related services falling by 26.8% as stock market volumes remain muted.

The Bank continued to make progress in offering a wide variety of investment funds to meet the changing risk appetites of investors under the low interest rate environment. These included funds from Hang Seng Investment Management and other providers. The first renminbi-denominated gold exchange-traded fund ("ETF") which caters for the growing demand for renminbi wealth management products was launched in 2012. Under the volatile equity market, investors shifted to fixed rate and lower risk bond funds which led to a 24.9% growth in the Bank's retail investment funds income.

Figures in HK$m	2012	2011
Life insurance:		
– net interest income and fee income	2,845	2,576
– investment returns on life insurance funds/share of associate's profit	761	(361)
– net earned insurance premiums	10,774	10,723
– net insurance claims incurred and movement in policyholders' liabilities*	(12,179)	(11,515)
– movement in present value of in-force long-term insurance business	815	595
	3,016	2,018
General insurance and others	310	364
Total	3,326	2,382

* Including premium and investment reserves

Insurance income increased strongly by HK$944m, or 39.6% to HK$3,326m, due mainly to the 49.5% increase in life insurance income, as a result of strong investment returns, higher insurance sales and movement in present value of in-force long-term insurance business. Hang Seng continued to launch new products catering for customers' investment and protection needs. This included the launch of the "SavourLife Annuity Life Insurance Plan". Total policies in-force and total annualised new premium at 31 December 2012 rose by 8.6% and 13.1% respectively year-on-year.

Net interest income and fee income from the life insurance funds investment portfolio rose by 10.4%, due mainly to growth in the size of the life insurance investment portfolio, which held bond investments as its major assets. Investment returns on life insurance funds improved strongly, recording a profit of HK$761m compared with a loss of HK$361m last year, reflecting changes in the fair value of assets held by the life insurance business, and benefited from the positive movements of equity markets and the upward commercial property market in 2012. To the extent that this fair value gain was attributed to policyholders of unit-linked life insurance policies, there was a corresponding increase in "net insurance claims incurred and movement in policyholders' liabilities".

The movement in present value of in-force long-term insurance business ("PVIF") increased strongly by 37%, due mainly to the combined effect of higher life insurance sales and more favourable market conditions.

General insurance business income decreased by 14.8% to HK$310m following the completion of the disposal of our general insurance manufacturing business to a third party insurance service provider in the second half of 2012 for a cash consideration of approximately HK$1,550m. The Bank recognised a disposal gain of HK$355m on this transaction. Subsequent to the disposal of general insurance manufacturing business, there will be an increase in non-life insurance products distribution commission with a corresponding decrease in non-life insurance underwriting profit.

Operating expenses rose by HK$491m, or 6.2%, to HK$8,389m.

The increase reflected the Bank's continued investments to support long-term business growth and capture business opportunities while maintaining carefully cost control and operational efficiency. Excluding the Mainland business, operating expenses rose by 4.7%.

Employee compensation and benefits increased by HK$249m, or 6.4%. Salaries and other related costs increased by 6.6%, reflecting the annual salary increment as a result of wage inflation. General and administrative expenses were up 5.8%, mainly due to the increase in marketing expenditure as more branding and promotional activities were conducted to support business growth. Rental expenses rose as a result of increased rents for branches in Hong Kong and new branches on the Mainland. Depreciation charges rose by 8.9%, reflecting higher depreciation charges on business premises following the upward property revaluation in Hong Kong.

Full time equivalent staff numbers by region

	2012	2011
Hong Kong	7,732	7,993
Mainland	1,883	1,772
Others	65	69
Total	9,680	9,834

At 31 December 2012, the Group's number of full-time equivalent staff decreased by 154 compared with the end of 2011.

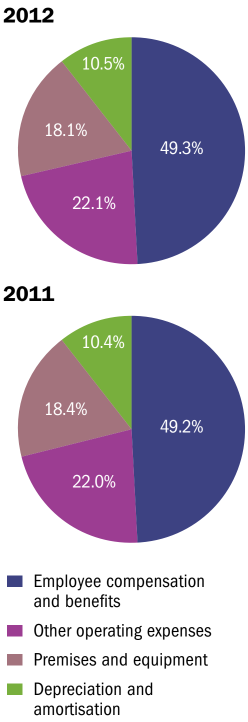
With the increase in net operating income before loan impairment charges outpacing the growth in operating expenses, the cost efficiency ratio declined by 0.6 percentage points to 34.4%, compared with 35.0% for 2011. The Bank continues to focus on improving operational efficiency while maintaining growth momentum.

Operating profit rose by HK$1,425m, or 10.0%, to HK$15,606m after accounting for the decrease in **loan impairment charges**.

Loan impairment charges decreased by HK$54m, or 12.3%, to HK$386m compared with a year earlier.

Figures in HK$m	2012	2011
Net charge for impairment of loans and advances to customers:		
Individually assessed impairment allowances:		
– new allowances	(294)	(359)
– releases	224	221
– recoveries	13	35
	(57)	(103)
Net charge for collectively assessed impairment allowances	(329)	(337)
Net charge for loan impairment	(386)	(440)

Operating Expenses



Overall credit quality was relatively stable and the Bank will remain cautious on the credit outlook.

Individually assessed impairment charges fell by HK$46m, or 44.7%, reflecting lower charges for corporate and commercial banking customers for Hong Kong operations in 2012, despite higher charges for Mainland operations due to the downgrading of certain commercial banking customers.

Collectively assessed charges fell by HK$8m, or 2.4%. Higher charges on credit card and personal loan portfolios were recorded, which reflected growth in the portfolios. Impairment allowances for loans not individually identified as impaired recorded a net release compared with a net charge in 2011, mainly due to improved historical loss rates.

Total loan impairment allowances as a percentage of gross loans and advances to customers are as follows:

	At 31 December 2012 %	At 31 December 2011 %
Loan impairment allowances:		
– individually assessed	**0.13**	0.19
– collectively assessed	**0.13**	0.16
Total loan impairment allowances	**0.26**	0.35

Profit before tax recorded growth of 14.8% to HK$22,113m after taking into account a HK$355m increase in **gain on disposal of a subsidiary**, reflecting the gain of HK$355m from the disposal of the Group's general insurance manufacturing business; a 21.8% (or HK$216m) fall in **net surplus on property revaluation**; and a 33.5% (or HK$1,349m) increase in **share of profits from associates**, mainly from Industrial Bank Co., Ltd. ("Industrial Bank") on the back of strong growth in its customer lending and higher fee-based income. On 7 January 2013, Industrial Bank completed a private placement of additional share capital to a number of third parties, thereby diluting the Group's equity holding from 12.8% to 10.9%. As a result of this and other factors, the Group considers it is no longer in a position to exercise significant influence over Industrial Bank and ceased to account for the investment as an associate from that date. For the financial year ended 31 December 2012, the Group's interest in Industrial Bank was recognised using the equity method based on the Industrial Bank's financial statement made up to 30 September 2012 in accordance with the Group's accounting policy. The Group will not equity account for its interest in Industrial Bank from 7 January 2013.

Gains less losses from financial investments and fixed assets fell by HK$55m, or 110%, compared with 2011.

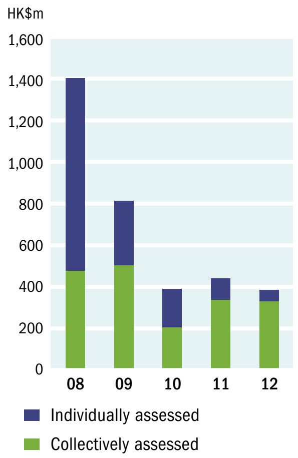
Net surplus on property revaluation fell by 21.8% to HK$776m.

Figures in HK$m	2012	2011
Surplus of revaluation on investment properties	**742**	982
Surplus of revaluation on assets held for sale	**34**	8
Reversal of revaluation deficit on premises	**–**	2
	776	992

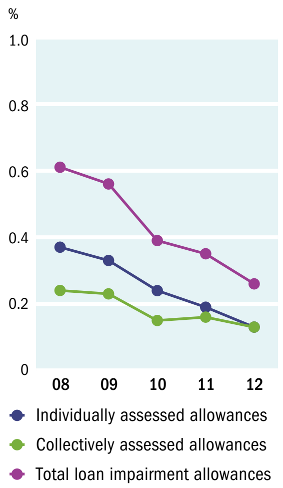
The Group's premises and investment properties were revalued at 30 November 2012 and updated for any material changes at 31 December 2012 by DTZ Debenham Tie Leung Limited. The valuation was carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use and the basis of valuation for investment properties was open market value. The net revaluation surplus for Group premises amounted to HK$2,222m which was credited to the premises revaluation reserve. A revaluation gain of HK$742m on investment properties was recognised through the income statement. The related deferred tax provision for Group premises was HK$360m.

The revaluation exercise also covered properties held for sale and a revaluation gain of HK$34m related to the investment property was recognised through the income statement.

Loan Impairment Charges



Loan Impairment Allowances as a Percentage of Gross Loans and Advances to Customers



Segmental Analysis

The table below sets out the profit before tax contributed by the business segments for the years stated.

	Hong Kong & other businesses						
Figures in HK$m	Retail Banking and Wealth Management	Corporate and Commercial Banking	Treasury	Other	Total	Mainland China business	Total
Year ended 31 December 2012							
Profit before tax	**7,939**	**5,878**	**2,364**	**509**	**16,690**	**5,423**	**22,113**
Share of profit before tax	**35.9%**	**26.6%**	**10.7%**	**2.3%**	**75.5%**	**24.5%**	**100.0%**
Share of profit before tax as a % of Hong Kong & other businesses	**47.6%**	**35.2%**	**14.2%**	**3.0%**	**100.0%**		
Year ended 31 December 2011 (restated)							
Profit before tax	6,509	4,616	2,512	1,433	15,070	4,185	19,255
Share of profit before tax	33.8%	24.0%	13.0%	7.5%	78.3%	21.7%	100.0%
Share of profit before tax as a % of Hong Kong & other businesses	43.2%	30.6%	16.7%	9.5%	100.0%		

Retail Banking and Wealth Management ("RBWM") in Hong Kong reported profit before tax of HK$7,939m in 2012, representing a 22.0% year-on-year increase. Excluding the general insurance business disposal gain, profit before tax was up 19.1%.

Net interest income reached HK$8,761m in 2012, representing a 10.6% year-on-year increase, which was mainly attributable to growth in deposit balances driven by the expansion in affluent customers, as well as the growth of unsecured lending and insurance businesses.

Year-on-year, total loans and deposits increased by 11.5% and 9.1% respectively. Mortgages as one of the core businesses, achieved good momentum throughout 2012, through offering innovative products including the Hang Seng Renminbi / Hong Kong Dollar Mortgage-Link launched in March 2012, a professional one-stop service and flexible sales channels to our customers. Amidst strong competition and the tightening of government measures on mortgage lending, our mortgage business maintained third position in the market, with our market share in terms of new mortgage registrations reaching 18.7% in 2012, representing a 6.2% year-on-year increase. The personal loans portfolio was also up 11.2% year-on-year.

Non-interest income grew by HK$309m to HK$3,822m while overall wealth management income grew by 18.6% to HK$5,328m.

Total operating income from the credit card business recorded year-on-year growth of 8.0% in 2012, supported by a high quality credit card customer base and effective marketing campaigns. Total cards in force reached 2.34 million, representing year-on-year growth of 5.1% and we were the third largest card issuer of VISA and MasterCard as of December 2012. Card spending and card receivables grew robustly by 10.7% and 9.8% year-on-year respectively.

The insurance business achieved a strong performance in 2012 with operating income increased by 45.5% year-on-year, underpinned by proactive management of investment assets, strong distribution and promotion efforts and an effective product diversification strategy. In 2012, we broadened our product suite by launching the SavourLife Annuity Life Insurance Plan, ProsperDragon Renminbi Life Insurance Plan and SurgicalGuard Refundable Life Insurance Plan, thereby attracting new customer segments as well as new sources of income. As a result, annualised life insurance new premiums grew by 13.3% and total life insurance policies in-force rose by 8.7% compared with last year.

Global market uncertainties, particularly from the second quarter onwards, adversely affected investor sentiment. Income from investment business decreased 4.0% compared with last year, primarily from lower securities brokerage. However, with our time-to-market investment solutions catering for customer needs, income and sales turnover of investment funds recorded encouraging growth of 35.7% and 73.7% respectively. New Hang Seng retail investment fund products, including the first renminbi-denominated gold exchange-traded fund ("ETF"), reinforced our reputation as a wealth management leader and a renminbi services pioneer. We have continued to build momentum in our investment fund business into this year. To provide diversified wealth management products to suit customers' needs, we launched the Hang Seng Gold Linked Deposits in January 2013 to meet the increased demand in gold investment products.

As a result of our continued effort to acquire quality customers, the numbers of Prestige and Preferred Banking customers increased by 10.7% and 8.3% respectively compared with 2011. To enhance the customer experience by providing modern environment and to attract affluent customers, a new Prestige and Preferred Banking Centre design concept has been introduced and a total of six Prestige and Preferred Banking Centres have already been opened. We have plans to open more Prestige and Preferred Banking Centres at strategic locations in the coming years.

Service excellence had always been our strength and we continued to receive recognition in the banking industry. We were named by The Asset as the "Best Domestic Bank in Hong Kong" for the 13th consecutive year in 2012. For the third consecutive year, Euromoney named the Bank as "Best Local Private Bank in Hong Kong" in the Private Banking Survey 2012 based on the assessment of business performance and peer nominations. We were also awarded the Reader's Digest "Trusted Brands GOLD Award" in the Bank category and the Credit Card Issuing Bank category in Hong Kong for the third consecutive year in 2012.

Corporate and Commercial Banking ("CNC") in Hong Kong achieved a 27.3% growth in profit before tax to HK$5,878m. Excluding the general insurance business disposal gain, profit before tax was up 23.7%.

Net interest income grew by 15.6% to HK$5,289m when compared with last year. CNC continued to provide customers with new and renewed facilities while adjusting pricing in line with the credit environment.

Year-on-year, total loans and deposits both grew by 10.4%. The growth in deposits was underpinned by a 21.4% increase in current and saving account deposit balances primarily contributed by new commercial customers.

Non-interest income rose by HK$123m to HK$2,101m. Net fee income reported a growth of 18.5%, which was driven by solid growth in a wide range of non-funds income streams – including remittances, trade, factoring and syndication loan facility fees. Income from corporate wealth management business was HK$634m, representing 8.5% of CNC's net operating income.

The momentum of quality commercial customer acquisition has accelerated in 2012 and the CNC customer base has increased by 12.8% in 2012. Mainland companies represented 45.7% of newly acquired customers in the second half of 2012 – compared with 34.2% in the first half of 2012.

Renminbi business remained one of our key strategic priorities. The number of renminbi accounts was up 25.1% in 2012 and CNC successfully made renminbi loans and will continue to explore such opportunities to achieve more balanced and sustainable growth. As at 31 December 2012, the size of the renminbi lending was three times of a year earlier.

In August 2012, CNC launched a new TV commercial to emphasise the edges of Hang Seng SME Business Loan – "Speed, Ease and Professional Service". This has reinforced Hang Seng's progressive image. Hang Seng was awarded "Excellent Brand of SME Loan Services – Hong Kong Leaders Choice Brand Awards 2012" by Metro Finance.

Network expansion and channel enhancements continued to be one of our key objectives. To strengthen our support to Mainland and Hong Kong corporates with cross-border business needs, two new Business Banking Centres were opened in the second half of 2012. Furthermore, Business Mobile Banking was launched in September 2012 to enhance customer convenience.

Focusing on structured finance and syndicated loans also contributed to our success. According to Thomson Reuters LPC, we ranked second in terms of number of deals and third in terms of deal volume in the Mandated Arranger League Table for Hong Kong and Macau Syndicated Loans in 2012.

In 2012, Hang Seng was awarded "Hong Kong Domestic Trade Finance Bank of the Year" and "Hong Kong Domestic Cash Management Bank of the Year" by Asian Banking and Finance. CNC would continue to leverage on the solid Hong Kong platform and loyal customer base to provide trade, cash management and wealth management solutions to corporate and commercial customers in Greater China.

CNC will continue to capitalise on her core strengths – customer-focused strategies and propositions, industry-specialised relationship teams, time-to-market and product innovations.

Treasury ("TRY") in Hong Kong recorded a 5.9% decrease in profit before tax to HK$2,364m and a 5.4% decline in operating profit excluding loan impairment charges to HK$2,363m.

Net interest income decreased by 11.3% to HK$1,676m. With the low interest rate environment and flattened yield curves, there were few opportunities for yield enhancement. Further, as balance sheet management portfolios matured, they could only be re-priced at prevailing rates which were relatively low.

Non-interest income grew by HK$104m to HK$960m. Total trading income increased by HK$110m, or 12.5%, to HK$988m. Option income from structured products achieved encouraging growth, boosted in part by rising demand for renminbi-denominated products following further liberalisation of renminbi business in Hong Kong. Faster growth in gross interest income from funding swaps also contributed to the increase. However, these increases were partly offset by a decline in income from securities and other trading.

Front-line channels (including e-Banking) and trading systems were enhanced to facilitate straight-through processing, enabling better position management. To reinforce our brand in gold-related business, the Hang Seng Gold Bar (physical gold product) and renminbi-denominated gold ETF were launched. Treasury will continue to position itself to capture yield enhancement opportunities by investing in Hong Kong and Mainland bonds and riding on yield curves of selected currencies. As the renminbi market in Hong Kong evolves, Treasury will continue to develop renminbi-denominated hedging and investment products to meet customer needs as well as explore new business opportunities for cross-selling treasury products with other customer groups.

Mainland China business

Hang Seng Bank (China) Limited ("Hang Seng China") expanded the scope and reach of our Mainland Chinese business in 2012, capitalising on the close integration of our Hong Kong and Mainland operations and an increasing awareness of our unique brand strengths. Hang Seng China strategically deployed resources to improve our foothold in regions with good long-term growth potential and further enrich our premium service proposition.

Hang Seng China opened one branch and six sub-branches, bringing the network to 46 outlets in 17 cities. Leveraging the favourable policies under CEPA, these new openings included three cross-city sub-branches in Guangdong province where we now have 21 outlets.

The operating environment in China was challenging in 2012 due to slower domestic economic growth and weakened external demand. The People's Bank of China has kept interest rates and the deposit reserve ratio unchanged since 6 July 2012 while using reverse repurchase agreements to maintain liquidity. The upper deviation to standard deposit rates and lower deviation to base lending rates were both widened, paving the way to further interest rate liberalisation. The competition for deposits and wealth management products was keen as foreign banks stepped up efforts to maintain revenue flows and market share.

Despite all the challenges, Hang Seng China has focused on growth of the portfolio, expansion of the customer base as well as diversification of revenue sources through differentiated business propositions for target customer segments and by exploiting opportunities in cross-selling and providing cross-border services between the Mainland and Hong Kong.

As a result, Hang Seng China maintained growth momentum. At 31 December 2012, the total number of Mainland customers (including both Corporate and Commercial Banking and Retail Banking and Wealth Management customers) rose by 12.6%, in which the total number of Prestige Banking customers increased by 15.5% over December 2011.

	As reported	Constant currency*
Year ended 31 December 2012 compared with 31 December 2011		
Total operating income	8.5%	6.6%
Operating profit	-28.8%	-29.8%
At 31 December 2012 compared with 31 December 2011		
Gross loans and advances to customers	15.5%	15.5%
Customer deposits	12.7%	12.7%

Total operating income grew by 8.5%, supported mainly by growth in net interest income, driven by growth in loans and advances to customers of 15.5%. Total deposits were 12.7% higher. Hang Seng China continued to emphasise credit quality over loan portfolio size, focusing on clients offering good potential for generating additional income streams through wealth management and trade services. Operating expenses increased by 15.3%, due largely to investments in long-term business growth. Together with a net loan impairment charge compared with a net release in 2011, this led to a 28.8% decline in operating profit.

The Bank worked closely with Industrial Bank and captured collaboration opportunities in various business areas during the year.

During the first quarter of 2012, Hang Seng Securities Limited ("Hang Seng Securities"), a wholly owned subsidiary of the Bank, and Guangzhou Securities Company Limited ("Guangzhou Securities"), a member of the Yue Xiu Group, received approval from the China Securities Regulatory Commission to establish a joint venture, Guangzhou GuangZheng Hang Seng Securities Investment Advisory Company Limited ("Guangzhou GuangZheng Hang Seng Securities"). The joint venture commenced business in the third quarter of the year and became the first joint venture securities investment advisory company in Guangdong province under Supplement VI to the Mainland and Hong Kong Closer Economic Partnership Arrangement ("CEPA"). The joint venture aims at becoming a showcase for cross-border securities investment advisory cooperation under CEPA by leveraging the strengths of both partners, and thus supporting the Bank's further business expansion in the Mainland.

Including the share of profit from Mainland associates, our mainland China business contributed 24.5% of total profit before tax, compared with 21.7% in last year, as a result of the strong growth in the Group's share of Industrial Bank's profit.

* Constant currency comparatives for 2011 referred to in the tables above are computed by translating into Hong Kong dollars the functional currency (renminbi) of Hang Seng's mainland China business:
- the income statement for 2011 at the average rates of exchange for 2012; and
- the balance sheet at 31 December 2011 at the prevailing rates of exchange on 31 December 2012.

Economic Profit

Economic profit is calculated from post-tax profit, adjusted for any surplus/deficit arising from property revaluation, depreciation attributable to the revaluation surplus and impairment of purchased goodwill and takes into account the cost of capital invested by the Bank's shareholders.

For the year 2012, economic profit was HK$12,938m, an increase of HK$2,421m, or 23.0%, compared with 2011. Return on invested capital rose by HK$2,857m.

	2012		2011	
	HK$m	%	HK$m (restated)	%
Average invested capital	71,583		62,837	
Return on invested capital*	19,070	26.7	16,213	25.8
Cost of capital	(6,132)	(8.6)	(5,696)	(9.1)
Economic profit	12,938	18.1	10,517	16.7

* Return on invested capital is based on post-tax profit excluding any surplus/deficit arising from property revaluation, depreciation attributable to the revaluation surplus and impairment of purchased goodwill.

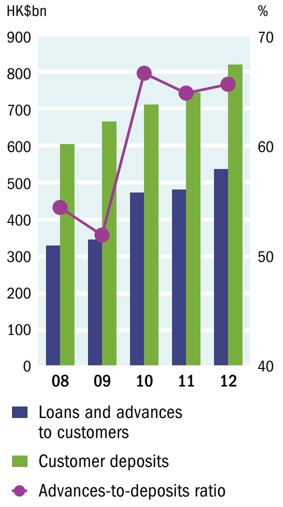
Balance sheet

Total assets rose by HK$101.4bn, or 10.4%, to HK$1,077.1bn. The Group continued to strengthen its asset and liability management and maintained a balanced growth strategy on loans and deposits. Loans and advances to customers increased by HK$55.6bn, or 11.6%, to HK$536.2bn, with growth in the commercial and corporate lending businesses, largely in mainland China. Residential mortgages grew as the Bank regained momentum in the year and reinforced its strong position in the residential mortgage sector and gained market share on the back of the active property market. Trade finance lending declined, due mainly to the maturing of certain cross border documentary credit loans during the year more than offsetting the growth in other trade finance loan products. Leveraging the strong connectivity between Hong Kong and mainland China operations, the Bank grew its Mainland lending during the year, driven mainly by renminbi loans. The Group remained vigilant in assessing credit risk in increasing lending on the Mainland. Customer deposits, including certificates of deposit and other debt securities in issue, increased by HK$75.6bn, or 10.2%, to HK$818.8bn. At 31 December 2012, the advances-to-deposits ratio was 65.5%, compared with 64.7% at 31 December 2011. Financial investments increased by 21.1% and trading assets decreased by 46.4%, reflecting the deployment of the commercial surplus to higher quality financial investments.

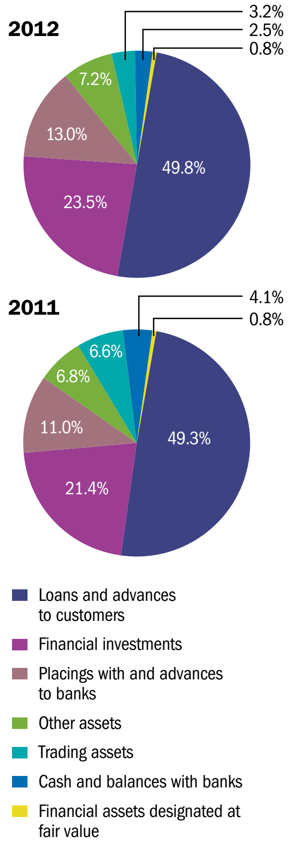
Assets Deployment

Figures in HK$m	2012	%	2011 (restated)	%
Cash and balances with banks	27,082	2.5	39,533	4.1
Placings with and advances to banks	140,382	13.0	107,742	11.0
Trading assets	34,399	3.2	64,171	6.6
Financial assets designated at fair value	8,343	0.8	8,096	0.8
Loans and advances to customers	536,162	49.8	480,574	49.3
Financial investments	253,408	23.5	209,190	21.4
Other assets	77,320	7.2	66,359	6.8
Total assets	1,077,096	100.0	975,665	100.0

Loans and Advances to Customers and Customer Deposits

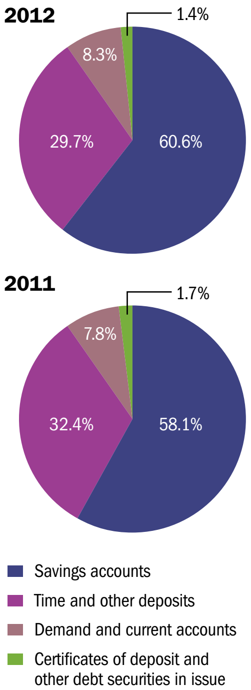


Assets Deployment



Financial Review

Customer Deposits



Loans and Advances to Customers

At 31 December 2012, gross loans and advances to customers were up HK$55.3bn, or 11.5%, at HK$537.6bn compared with the end of 2011.

Loans for use in Hong Kong increased by HK$34.9bn, or 10.2%. Lending to industrial, commercial and financial sectors grew by 8.8%. Lending to the property development and investment sectors remained active and grew by 4.2% and 3.0% respectively, supported by a buoyant commercial property market during the year. With strong customer relationships, active participation in Hong Kong Government-organised schemes, and enhanced service capabilities, the Bank continued to support customers in growing their businesses, with 42.9% growth in the wholesale and retail trade sector and 15.9% in manufacturing sector.

Lending to individuals increased by 12.0% compared with last year-end. As the property market remained active, residential mortgage lending to individuals rose by 16.4%, as a result of the Bank's aim to be a preferred mortgage bank that provides comprehensive mortgage services despite strong market competition. Credit card loans and advances grew by 9.9% supported by the rise of 5.4% in the number of cards in circulation and an 11.1% increase in cardholder spending.

Trade finance declined by 4.0% against last year-end as certain cross border documentary credit loans matured during 2012, partly offset by the growth in other trade finance loan products.

Loans for use outside Hong Kong rose by 24.5%, compared with the end of 2011, driven largely by lending on the Mainland. The Mainland loan portfolio increased by 15.5% to HK$51.6bn, underpinned by the expansion of renminbi lending to corporate borrowers. The Group remained vigilant in assessing credit risk in increasing lending on the Mainland.

Customer Deposits

With the Bank's successful effort in acquiring new customers in target segments, customer deposits, including current, savings and other deposit accounts and certificates of deposit and other debt securities in issue, increased by HK$75.6bn, or 10.2%, to HK$818.8bn at 31 December 2012. Higher growth was recorded in Hong Kong dollar currency deposits. Structured deposits increased as instruments with yield enhancement features gained popularity. Deposits in Hang Seng China also rose by 12.7%, driven mainly by renminbi deposits.

Subordinated Liabilities

The outstanding subordinated loan debts, which qualify as supplementary capital, serve to help the Bank maintain a balanced capital structure and support business growth.

Shareholders' funds

Figures in HK$m	At 31 December 2012	At 31 December 2011 (restated)
Share capital	9,559	9,559
Retained profits	59,683	49,519
Premises revaluation reserve	13,790	12,280
Cash flow hedging reserve	17	6
Available-for-sale investment reserve		
– on debt securities	(57)	(756)
– on equity securities	284	195
Capital redemption reserve	99	99
Other reserves	5,124	5,099
Total reserves	78,940	66,442
	88,499	76,001
Proposed dividends	3,824	3,633
Shareholders' funds	92,323	79,634
Return on average shareholders' funds	22.9%	22.7%

Shareholders' funds (excluding proposed dividends) grew by HK$12,498m, or 16.4%, to HK$88,499m at 31 December 2012. Retained profits rose by HK$10,164m, mainly reflecting growth as a result of the 2012 profit after the appropriation of interim dividends during the year. The premises revaluation reserve increased by HK$1,510m, or 12.3%, on the back of the buoyant property market during the year.

The available-for-sale investment reserve for debt securities recorded a deficit of HK$57m compared with a deficit of HK$756m at the end of 2011, reflecting the decrease in the Group's share of associate's available-for-sale investment reserve deficit as a result of the interest rate movement and the narrowing of credit spreads of debt securities of the Group's investment portfolios. The Group assessed that there were no impaired debt securities during the year, and accordingly, no impairment loss has been recognised.

The return on average shareholders' funds was 22.9%, compared with 22.7% for 2011.

Excluding the redemption of all the US$300m floating rate subordinated notes due 2017 at par on 6 July 2012, there was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's securities during 2012.

Risk Management

The effectiveness of the Group's risk management policies and strategies is a key success factor. Operating in the financial services industry, the most important types of risks the Group is exposed to are credit, liquidity, market, legal, operational, reputational and strategic. The Group has established policies and procedures to identify, measure, analyse and actively manage the risks and to set appropriate risk limits to control this broad spectrum of risks. In line with best practices, the Bank's Risk Management Committee exercises oversight of the risk management framework for the Bank. The Risk Management Committee is constituted by the Board and accountable to the Executive Committee. Its main functions are to review, analyse, evaluate, recognise and manage various risks of the Bank and is responsible for approval of all risk management related policies and major control limits. Risk limits are monitored and controlled continually by dedicated departments by means of reliable and up-to-date management information systems. The management of various types of risks is well coordinated at the level of the Bank's Board and various Management committees, such as, the Executive Committee, Risk Management Committee and Asset and Liability Management Committee.

Note 62 "Financial risk management" to the financial statements provides a detailed discussion and analysis of the Group's credit risk, liquidity risk, market risk, insurance risk, operational risk and capital management. The management of reputational risk is set out as follows:

Reputational risks can arise from social, ethical or environmental issues, or as a consequence of operational risk events. Standards are set and policies and procedures are established in all areas of reputational risk and are communicated to staff at all levels. These include fair and transparent dealings with customers, conflicts of interest, money laundering deterrence, environmental impact and anti-corruption measures. The reputational downside to the Group is fully appraised before any strategic decision is taken.

The Group is a socially and environmentally responsible organisation. Its corporate responsibility policies and practices are discussed in the corporate responsibility section of this annual report.