

CHIEF EXECUTIVE'S REPORT

In the difficult first half of 2001, Hang Seng's reputation for quality and focus on relationship enhancement enabled the Bank to strengthen its abilities to compete in the market. We further improved our financial position.

Attributable profit rose to HK\$5,375 million, an increase of 3.5 per cent over the same period in 2000 and a rise of 11.5 per cent compared with the second half of 2000.

Our strategy to expand wealth management initiatives and fee-based services saw the ratio of non-interest income to total income rise to 24.7 per cent, compared with 23.6 per cent in the first half of 2000. Reflecting our asset quality, the net charge for bad and doubtful debts decreased substantially by 74.7 per cent to HK\$21 million compared with the same period a year earlier.

Hang Seng's measures to develop and strengthen relationships with customers, to encourage them to look to the Bank for all their banking needs, and to reward them for total banking relationships were well-received.

Financial highlights

Operating profit before provisions grew by 0.1 per cent to HK\$5,967 million compared with the first half of 2000, with an increase in operating income offsetting higher operating expenses.

Net interest income rose slightly by 0.3 per cent to HK\$5,902 million. Although average interest-earning assets grew by 10.1 per cent, the net interest margin fell by 25 basis points to 2.58 per cent. This was attributable to the 14 basis point reduction in the net interest spread to 2.21 per cent and the 11 basis point fall to 0.37 per cent in the contribution from net free funds.

The net interest spread was adversely affected by a further decline in the average yield on the mortgage portfolio and narrower spread earned on time deposits in the low interest rate environment. These factors outweighed the benefits of growth in lower cost savings deposits, a higher yield on investment securities and a wider gap between BLR and HIBOR.

Income from net free funds fell by HK\$287 million due to the reduction in market interest rates. Excluding this factor, net interest income would have grown by 5.2 per cent.

Compared with the second half of 2000, net interest income improved by 1.6 per cent, with a three basis point rise in the net interest margin of 2.58 per cent and a 17 basis point rise in the net interest spread of 2.21 per cent.

Other operating income rose by 6.1 per cent to HK\$1,931 million compared with the first half of 2000. Net fees and commissions rose by 7.5 per cent to HK\$1,124 million.

Operating expenses increased by 7.3 per cent. Staff costs rose by 1.9 per cent, largely due to the salary award while premises and equipment expenses grew by 26.2 per cent, mainly reflecting the growth in IT expenditure to support new e-initiatives.

The cost:income ratio was 23.8 per cent, compared with 22.6 per cent for the first half of 2000. Reflecting the Bank's cost-efficiency, pre-tax profit per employee rose by 0.2 per cent to HK\$833,000.

We maintained strong liquidity and remained well-capitalised. The average liquidity ratio for the first half of 2001 was 46.0 per cent, compared with 41.4 per cent for the year-earlier period. The total capital ratio at 30 June was 15.8 per cent, compared with 15.3 per cent six months earlier, and the tier 1 capital ratio was 12.6 per cent, compared with 11.9 per cent.

Asset quality

The net charge for bad and doubtful debts fell substantially by 74.7 per cent to HK\$21 million compared with the first half of 2000.

The net charge for specific provisions fell by 65.0 per cent to HK\$21 million, benefiting from a substantial increase in recoveries and releases of specific provisions from corporate accounts. The increase in new and additional provisions was mainly for residential mortgages and commercial banking customers. As the balance of the additional general provision of HK\$125 million was transferred to general provisions at 31 December 2000, no charge for general provisions was made against loan growth during the first half of 2001.

The ratio of total provisions to gross advances to customers continued to fall, by 0.23 of a percentage point to 1.78 per cent compared with the end of 2000. Specific provisions decreased from 1.36 per cent to 1.14 per cent and general provisions fell from 0.65 per cent to 0.64 per cent.

Gross non-performing advances (after deduction of interest in suspense) fell by HK\$830 million, or 11.2 per cent, to HK\$6,604 million compared with the end of 2000.

The ratio of non-performing advances (after deduction of interest in suspense) to total gross advances fell by 0.3 percentage point to 3.0 per cent. Specific provisions plus collateral that is conservatively valued amounted to almost 100 per cent of non-performing advances.

Customer relationship management

We aim to be the bank of first choice for customers. In April, we announced measures to strengthen relationships with customers while rewarding them for total banking relationships. This followed a review of the price structure of our savings deposits in the face of full interest rate deregulation.

The measures strike a balance between our role as a community bank and our responsibilities to shareholders. They offer customers choice through the provision of a number of service packages that meet different needs.

On 1 May, a four-tier interest rate structure was introduced for savings accounts which pays interest to customers in the context of their relationship with the Bank.

Since July, customers with savings deposits of HK\$150,000 or more are offered a fifth tier of higher interest rate which depends on market conditions. To further promote integrated accounts which facilitate product cross-selling, bonus interest is also offered to such account-holders if their total relationship balance reaches HK\$150,000.

The Bank believes that social responsibility and customer loyalty should balance purely commercial considerations. On this basis, more than two million savings accounts have been exempted from the new fee introduced in July on Hong Kong dollar savings accounts with an average balance below HK\$5,000. New accounts opened by certain groups of people, including senior citizens and minors, are not subject to the new fee. Customers with integrated accounts and other bank products also get exemptions.

We are also encouraging customers to migrate from counters to cost-efficient automated channels. The response to the ATM Savings Account, which has no minimum balance requirement, has been satisfactory. From its introduction in April until the end of June, more than 12,200 such accounts had been opened.

Business performance

Our focus on higher-margin, value-creating businesses includes wealth management delivery and growing our commercial banking business. Our e-Banking services continue to grow as part of our efforts to provide better service to existing customers and attract new ones. We are also expanding in mainland China.

In our major businesses, personal financial services remained the major profit contributor, providing 44.6 per cent of the HK\$6,183 million profit before tax. Corporate and institutional banking contributed 9.4 per cent, commercial banking 11.1 per cent and treasury 14.0 per cent of pre-tax profit. Others, which mainly represents shareholders' funds and investments in premises, investment properties and long-term equities, provided 20.9 per cent of pre-tax profit.

Current, savings and other deposit accounts declined by 3.3 per cent to HK\$415.5 billion compared with the end of 2000. The decline in HKD deposits was mainly in time deposits and certificates of deposits issued, while savings deposits continued to grow. USD and other foreign currency deposits also decreased.

We increased our market share of loans despite weak demand in the market. Advances to customers (after deduction of interest in suspense and provisions) grew by 1.0 per cent to HK\$219.8 billion, compared with a fall in the market.

Residential mortgages, excluding those under the Government Home Ownership Scheme and Staff Housing Loan Scheme, fell by 1.7 per cent, due to intense competition and lack of activity in the secondary property market. Due to the further fall in the pricing of new mortgages and the repricing of existing loans, the average yield of the residential mortgage portfolio fell to 65 basis points below BLR for the first half of 2001, before accounting for the effect of cash incentive payments. This compared with five basis points above BLR and 57 basis points below BLR in the first and second halves of 2000 respectively.

Major businesses

Personal financial services recorded a fall of 10.8 per cent in pre-tax profit compared with the same period last year. This was mainly due to the decline in mortgage yields which outweighed the income growth in wealth management businesses.

In order to strengthen segmentation and enhance wealth management delivery to affluent customers, Prestige Banking was launched in March for customers with a total relationship balance of HK\$500,000. A total of 31 Prestige Banking Centres have been set up.

Income from our wealth management initiatives, which comprise investment and insurance services, grew by 4.9 per cent compared with the same period in 2000. Investment fund subscription rose by 24.2 per cent, benefiting from the successful launch of funds suited for the current investment environment. Nine new funds were launched under the Hang Seng Investment Series in the first half of 2001, taking the total to 26. Funds managed under the Series grew by 123.2 per cent to HK\$8.9 billion from the end of 2000.

Securities broking and related income were adversely affected by the depressed stock market but the Bank's market share in stock trading increased.

Hang Seng Life made good progress, with annualised new premiums for life insurance growing by 68.1 per cent. Our Mandatory Provident Fund (MPF) business began to generate income, with the number of enrolled employees and self-employed persons rising to 198,500 at the end of June.

Credit card advances showed satisfactory growth of 5.1 per cent to HK\$5.0 billion as a result of the expansion in the card base. Personal lending increased by 21.9 per cent to HK\$5.9 billion, reflecting the success of the Bank's strategy to diversify its individual loan portfolio.

The Bank continued to enhance the scope of its e-Banking services, which are available to credit card holders, employees enrolled in its MPF schemes and sole proprietors as well as integrated account customers. More than 134,500 customers had registered at the end of June.

e-Banking services are now an important part of our integrated multi-channel delivery network and play a significant role in cross-selling wealth management products to customers. In June, internet transactions made up 8.8 per cent of total transactions and about 50 per cent of the Bank's securities transactions by count were conducted online.

Commercial banking, which manages middle market and smaller corporate relationships, showed an increase of 7.0 per cent in pre-tax profit. In the first half of 2001, trade finance advances recorded encouraging growth of 16.0 per cent despite dampened export trade and the Bank's market share increased. Steady growth was also recorded in commercial lending.

In the Mainland, Fuzhou Branch opened in February and the first representative office of Hang Seng Insurance Company Limited opened in Shenzhen in April. Total advances to Mainland-related entities grew by 2.2 per cent to HK\$10.5 billion at the end of June, and Mainland-related advances amounted to 4.7 per cent of total advances.

Corporate and institutional banking achieved growth of 26.4 per cent in pre-tax profit, mainly benefiting from a substantial recovery of bad and doubtful debts. Treasury recorded growth of 40.0 per cent in pre-tax profit, reflecting successful positioning of portfolios to benefit from the downward trend in interest rates.

Good citizenship

An important part of our role in the community is our support for philanthropic and sponsorship programmes, particularly in the areas of education, community services and sports.

Since 1995, the Bank has allocated over HK\$24 million to its scholarship schemes, benefiting more than 330 students. The award of scholarships to four Hong Kong and Mainland students to study abroad from September took the total number of students benefiting from the Hang Seng Bank Overseas Scholarship Scheme to 22.

Our community programmes were extended to the e-world. The Hang Seng Coin Box Charity e-Auction raised HK\$330,000 for the Community Chest, with the auction over the internet of 37 collectable coin boxes issued by the Bank in the 1970s and 1980s. Since 1990, the Bank has made

charitable donations exceeding HK\$110 million to the needy, including about HK\$15 million to the Community Chest.

The Hang Seng Table Tennis Academy was established in March as the first academy for a single sport in Hong Kong and is expected to benefit about 30,000 participants from 2001-2003. The Bank's sponsorship of the Academy will take its total sponsorship amount for the promotion of the sport to over HK\$15 million since 1991.

HSI Services Limited, a wholly owned subsidiary, announced the launch on 3 October of the Hang Seng Composite Index Series, as part of its continuing efforts to provide comprehensive index services to meet different investor needs.

Looking ahead

In the second half of 2001, the operating environment will remain difficult for banks, with continued high liquidity, narrowing interest margins, intense competition and subdued loan demand.

Hang Seng will continue to focus on value-creating businesses and build more profitable long-term customer relationships to achieve sustainable growth. Product diversification, customer segmentation and needs-based cross-selling will be strengthened to meet more sophisticated customer needs. Asset quality and cost discipline will remain important.

It is too early to say what the impact of July's full interest rate deregulation will be on margins and earnings. As the deregulation coincided with abundant market liquidity, competition for deposits among banks is not likely to be strong in the short term. We shall closely monitor the market and continue to enhance our products and services to build total customer relationships.

We shall continue to use leading edge technology to reach more customers and increase flexibility and convenience for them. Plans are afoot for the launch of new online services, including business internet banking.

In our commercial banking business, we shall further expand our customer base of small and medium-sized enterprises. Our MPF enrolments have provided a large customer base among this group to whom to cross-sell wealth management products.

The Mainland offers vast opportunities in the medium term and we are planning to increase our network of branches and offices in strategically important locations. Hang Seng Securities Limited has recently submitted applications with a view to obtaining B shares trading seats on both the Shanghai and Shenzhen Stock Exchanges and to setting up a representative office in Shanghai.

Applications were lodged by the Bank in 2000 for a renminbi licence in Shanghai, to open a branch in Nanjing and to upgrade its Beijing representative office to a branch.

In a challenging environment, our strong franchise and premium service coupled with our solid track record and sound growth strategies, will enable us to respond speedily to customer needs and enhance shareholder value.

Vincent H C Cheng

Vice-Chairman and Chief Executive

Hong Kong, 6 August 2001