

Chief Executive's Report

The year 2002 proved to be very demanding. Hang Seng's prudent management and relationship building strategies enabled the Bank to meet new challenges and deliver high quality services. We endeavoured to become the provider of choice for financial services.

We were able to expand non-interest income and reduce costs. Our ratio of other operating income to total operating income rose by 3.1 percentage points to 28.4%, compared with 2001. The cost:income ratio fell by 0.9 percentage point to 25.4%, among the lowest in the banking world, as a result of strict expense discipline.

We further expanded our comprehensive range of one-stop solutions. We concentrated on the high growth businesses of wealth management and SME (small and medium-sized enterprises) services.

Strong Partnerships

The Bank has grown and prospered with Hong Kong in the past 70 years. We owe our enduring success to our solid partnerships with customers.

We seek to develop strong, lasting customer relationships based on mutual value creation. In particular, we are delivering service excellence and greater value to customers through segmentation.

Our personal integrated accounts enhance the customer experience, offer privileges to enrich their lifestyle and provide customised solutions catering for their life stages.

With in-depth knowledge of customer needs, we are able to meet their financial aspirations, especially in wealth management.

We added Stamina Banking and BIA Junior to the family of lifestyle banking integrated accounts in 2002.

During the year, Prestige Banking Centres for affluent customers were increased by 26 to 59. ezLink Financial Services was introduced for commuters between Hong Kong and the Mainland.

Our private banking service reached out to more high net worth customers and offered a wider range of financial products to meet individual wealth management needs.

Our corporate and institutional banking division is teaming up with treasury and markets to meet the more sophisticated needs of large corporate customers.

Our commercial banking business serves the needs of large, medium and small businesses. We set up the Business Banking Division to strengthen relationships with SME customers. We have 11 Business Banking Centres throughout the territory.

Financial Highlights

Operating profit before provisions fell by 2.2% to HK\$11,255 million, compared with 2001. Profit before tax amounted to HK\$11,242 million, a reduction of 2.4%.

Whether our business customers are just starting out or are already well-established, we understand their requirements and help enhance their financial management.



Net interest income decreased by 7.3% to HK\$10,805 million, mainly attributable to the fall in contribution from net free funds. A compression of 10 basis points in net interest margin to 2.46% was the net effect of a rise of 8 basis points in net interest spread and a reduction of 18 basis points in the contribution from net free funds.

Net interest spread was 2.36%, gaining from improved spreads on the holding of investment securities, growth in lower cost savings deposits and wider spread earned on time deposits. These were partly offset by a further decline in the average yield on the mortgage portfolio. The contribution from net free funds fell to 0.10%, which accounted for a reduction of about HK\$850 million in net interest income.

Other operating income rose by 8.5% to HK\$4,282 million.

Net fees and commissions grew by 8.2% to HK\$2,605 million, mainly attributable to the increase of 89.2% to HK\$700 million in fees from the distribution and management of retail investment funds.

Income from wealth management services, comprising income from investment and insurance, grew strongly by 32.6% to HK\$1,608 million, indicating increased product cross-selling to customers. It represented 37.6% of total other operating income.

Operating expenses fell by 6.6%, reflecting the Bank's strict cost discipline. Staff costs decreased by 9.2%, mainly due to non-recurrence of the special top-up contribution to the

staff retirement benefit scheme made in 2001. The total staff number fell by 209 to 7,279, and by 769 from its height in 1997.

The net charge for bad and doubtful debts amounted to HK\$571 million, an increase of 34.7% compared with the previous year.

New and additional specific provisions rose by 8.5% to HK\$1,231 million. A reduction in specific charges for corporate accounts and residential mortgages was offset by the rise in specific charges for card advances and personal loans due to the rise in bankruptcies. Releases and recoveries were reduced by 53.6% to HK\$330 million, mainly from taxi loans and corporate accounts.

There was a release of HK\$330 million from general provisions. This reflected a reduction in our estimate of the latent loan losses which had occurred at the balance sheet date. The estimate was based on the historical experience of the rate at which such losses occur and are identified, the structure of our loan portfolio and the prevailing economic and credit conditions.

The ratio of total provisions as a percentage of gross advances to customers fell to 1.28% at 31 December 2002, compared with 1.55% a year earlier. Specific provisions decreased by 0.12 percentage point to 0.79%. General provisions fell by 0.15 percentage point to 0.49%.

Gross non-performing advances (after deduction of interest in suspense) fell by 1.5% to HK\$6,081 million. The ratio of gross non-performing advances to gross advances to customers was maintained at 2.7%, the same level as at the end of 2001. Specific provisions plus collateral that is conservatively valued amounted to almost 100% of non-performing advances.

We continued to maintain strong liquidity. The average liquidity ratio in 2002 was 44.4%, compared with 45.6% in 2001.

The total capital ratio at 31 December 2002 was 14.2% and the tier one capital ratio was 11.9%. This compares with 15.3% and 12.3% respectively a year earlier.

Loans and Deposits

Hang Seng increased its market share of total deposits and loans for use in Hong Kong in 2002.

Customer deposits were maintained at HK\$413.7 billion, which was only marginally lower than the HK\$414.3 billion at the end of 2001. Funds continued to shift from time deposits to savings deposits under the persistently low interest rate environment.

Advances to customers (after deduction of interest in suspense and provisions) recorded modest growth of 1.0% to HK\$224.6 billion, as loan demand remained subdued in the uncertain economic environment.

Lending to the industrial, commercial and financial sectors grew by 4.6%, mainly recorded in lending to property investment companies and working capital financing of large corporations.

A decrease of 10.8% was recorded in advances under the suspended Government Home Ownership Scheme (GHOS) and other government sponsored home purchasing schemes. Excluding such advances, total lending to individuals rose by 1.7%. Residential mortgages and credit card advances recorded moderate growth amidst intense market competition.

As a result of the continued reduction in the pricing of new mortgages and the re-pricing of existing loans, the average yield on the residential mortgage portfolio, excluding GHOS mortgages and staff loans, fell from 84 basis points below BLR in 2001 to 149 basis points below BLR in 2002. This was before accounting for the effect of cash incentive payments.

Trade finance rose by 3.4%, benefiting from the improvement in Hong Kong's external trade.

Total advances to Mainland-related entities grew by 2.3% to HK\$9.8 billion and accounted for 4.3% of total advances at the year-end.

Lines of Business

Personal financial services remained the major profit contributor, providing 49.4% of the profit before tax. Commercial banking contributed 9.9% of pre-tax profit, corporate and institutional banking 8.3% and treasury 17.7%. Other businesses, which mainly cover the management of shareholders' funds and investments in premises, investment properties and long-term equities, provided 14.7% of pre-tax profit.

Personal financial services recorded growth of 6.6% in profit before tax. Despite the prolonged decline in the average mortgage yield and the contraction in the GHOS mortgage portfolio, net interest income only recorded a marginal fall of 1.7%, benefiting from the continued shift of customer deposits to lower cost savings accounts.

Other operating income rose by 16.8%, mainly in wealth management services.

Sales of retail investment funds, including the popular Hang Seng Investment Series, increased by 46.7% from the previous year. The Investment Series comprised a total of 60 retail funds at the year-end, including 42 capital guaranteed funds – the largest set of capital guaranteed funds in number in Hong Kong.

Total funds under management, including investment funds and private banking funds, grew by HK\$15.2 billion, or 60.1%, to HK\$40.6 billion at the year-end.

Commercial banking recorded satisfactory loan growth of 13.1%, mainly in trade finance and other lending to the manufacturing sector. However, net interest income suffered from the compression in lending and deposit margins, and profit before tax decreased by 6.9%.

The operating result was also affected by a reduction in Mandatory Provident Fund services income due to higher commissions received from new customers in the previous year.

Corporate and institutional banking reported a decline of 4.9% in profit before tax. The operating result was affected by the compression in lending margins.

Treasury recorded growth of 2.9% in profit before tax. Net interest income rose by 3.8% as more funds were redeployed from interbank placing to the capital market for yield enhancement. The fixed rate debt securities portfolio continued to benefit in a low interest rate environment.

Other Business Operations

There were several milestone developments in mainland China, where Hang Seng operates branches in Guangzhou, Shanghai, Shenzhen and Fuzhou and representative offices in Beijing and Xiamen.

Our Shanghai branch launched renminbi services for foreign passport holders; citizens of the Hong Kong SAR, Macau SAR and Taiwan; and foreign-invested enterprises.

Our one-stop financial solutions help customers protect and grow their assets while they enjoy the finer things in life.



As the banking partner of choice, we provide 'any time, any place' e-Banking services to bring new opportunities and maximum convenience to customers.



The Guangzhou, Shanghai and Shenzhen branches began foreign currency services for mainland Chinese citizens and corporations, and opened Prestige Banking Centres during the year.

Personal e-Banking services were launched for customers of our four Mainland branches and should make our presence felt more strongly.

Hang Seng Securities Limited opened a representative office in Shanghai and Hang Seng Investment Management Limited obtained approval to open a representative office in Shenzhen.

In Taiwan, we opened our first representative office in Taipei.

e-Banking services have become an important part of our integrated multi-channel delivery network, helping us to increase product sales.

During 2002, Business e-Banking services were launched to help commercial customers and SMEs manage their company finances more efficiently and minimise costs through savings on transactional charges.

At the year-end, the number of customers registered for Personal e-Banking services had grown to more than 250,000, an increase of 42.6% from a year earlier. The number of internet transactions had risen to over 14% of total transactions and online share trading to about 55% of total securities transactions.

As our internet banking services become more popular, our branches are focusing on more personalised services and customer relationship deepening. Counter transactions fell to 15.7% of total transactions in 2002, compared with 17.2% in 2001.

We currently operate 157 branches and automated banking centres in Hong Kong.

Building Team Spirit

We promote teamwork in our working environment, nurture the service culture and encourage innovation.

Staff are committed to manage for value, share best practices and take responsibility together for the Bank's performance. Their joint efforts saw attributable profit rise to a record HK\$1.37 million per employee in 2002, compared with HK\$1.35 million in 2001 and HK\$0.79 million in 1992.

We invest in the staff and care for their well-being and personal development. Training helps staff meet regulatory requirements and business demands, and to achieve their individual potential.

Our staff put forward about 855 ideas to improve services and capture business opportunities in 2002. Cost savings and revenue generation from the implementation of ideas in 2002 reached HK\$12.8 million, taking the total since 1992 to HK\$127 million on an annual recurring basis.

Future Prospects

2003 will be another challenging year. Hang Seng will continue to exercise great vigilance in its business in an environment of intense competition, weak loan demand and narrowing margins.

The Bank will build on its large customer franchise, financial strength and efficient operations, at the same time offering customers added value and premium service.

We shall continue to focus on customer segmentation and introduce more lifestyle banking services to become the preferred financial partner of customers.

In our higher margin, value-creating businesses of wealth management and SME services, we intend to increase non-interest income, product cross-selling and market share wherever we can through relationship building and widening our product range.

In Hong Kong, there is increasing awareness of the need for lifetime wealth management. We are growing both the affluent and mass affluent customer segments in this business, which offers vast potential.

SMEs are the cornerstone of Hong Kong businesses and we shall expand our customer base in this sector.

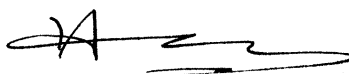
Our e-Banking services will be further enhanced for service differentiation, both in Hong Kong and mainland China.

The Mainland remains a long term strategic investment. We are expanding our network with more branches and sub-branches in major cities and through internet banking services. We are preparing for the opening of our Nanjing Branch. A sub-branch in Puxi, Shanghai, is expected to commence business later this year.

We have also applied for our Guangzhou and Shenzhen branches to offer renminbi services.

In other developments, we are looking into the Mainland credit card market. In addition, our insurance, securities and investment businesses are positioning themselves in the Mainland.

In the challenging operating environment, Hang Seng is committed to sustaining superior performance. We are a financially sound bank with a strong customer focus, good business base and steady record of profits. We shall make the most of our many strengths to maximise profitability and to be the bank of choice.



Vincent H C Cheng

Vice-Chairman and Chief Executive

Hong Kong, 3 March 2003

Major Awards and Ratings

For Hang Seng Bank

- Named the Best Local Bank in Hong Kong by *FinanceAsia* magazine.
- Named the Best Domestic Commercial Bank and ranked third for best corporate governance in Hong Kong by *The Asset* magazine.
- Voted the Best Retail Bank by *Capital* magazine.
- Received the Best Investor Relations by a Hong Kong Company award at the Investor Relations Magazine Asia Awards.
- Ranked first for best operational efficiency and second for best treatment of minority shareholders in Hong Kong by *Asiamoney* magazine.
- Ranked third for strongest commitment to enhancing shareholder value in Hong Kong by *FinanceAsia*.
- Ranked third for financial soundness in Hong Kong in the REVIEW 200 poll.
- Long-term local currency deposit rating of Aa3, short-term foreign currency deposit rating of Prime 1 and long-term foreign currency deposit rating of A3 from Moody's Investors Service. Bank Financial Strength Rating of B – the highest rating among Moody's rated Hong Kong banks.
- Api credit rating from Standard & Poor's – the highest rating based on public information for banks in Hong Kong – was affirmed.
- Individual rating of A/B from Fitch – the highest for banks in Asia – was affirmed.
- Won the Public Sector Award for the 'Hang Seng Bank – Help the Police Fight Youth Crime Competition' in the PRWeek Awards.
- Won a Gold Quill Award for role in the establishment of the Hang Seng Table Tennis Academy.
- Won the 'Yahoo! Prime Users Most Emotive Brand Award' and 'Award for the Brand Yahoo! Users Trust the Most'.

For Hang Seng Life Limited

- Assigned A+ insurer financial strength and counterparty credit ratings by Standard & Poor's.

For Hang Seng Insurance Company Limited

- Assigned A+ insurer financial strength and counterparty credit ratings by Standard & Poor's.