

## CHIEF EXECUTIVE'S REPORT

Hang Seng Bank's financial and operating strengths enabled it to meet the challenges of the adverse economic environment and the effects of SARS in the first half of 2003.

Operating profit before provisions rose by 3.8% to HK\$6,073 million, compared with the first half of 2002. Attributable profit, however, fell by 3.8% to HK\$5,022 million due to increased provisions, a higher rate of profits tax imposed in the last budget and a further decline in the value of properties held.

Compared with the second half of 2002, operating profit before provisions and attributable profit increased by 12.3% and 6.9% respectively.

Profit before tax amounted to HK\$5,928 million, a reduction of 0.8% compared with the first half of 2002 but an increase of 12.6% from the second half of 2002.

We made significant progress in implementing our wealth management initiatives to increase non-interest income and in managing costs.

Our ratio of other operating income to total operating income rose by 5.0 percentage points to a record 33.9%, compared with the first half of 2002.

The cost:income ratio improved to 23.1%, 0.6 percentage point lower than the same period in 2002 and 4.1 percentage points below the level of the second half of 2002.

We continued to focus on customer segmentation and widened our product range to meet new customer demands in the low interest rate environment. We also made inroads in growing our commercial banking business and mainland China operations.

### Financial highlights

Net interest income decreased by HK\$233 million, or 4.3%, to HK\$5,220 million, compared with the first half of 2002. Net interest margin narrowed by 8 basis points to 2.41%, with a reduction in net interest spread of 5 basis points to 2.33% and a fall in contribution from net free funds of 3 basis points to 0.08%.

Other operating income recorded encouraging growth of 20.9% to HK\$2,674 million. Income from wealth management, comprising income from investment and insurance services, grew strongly by 37.2% to HK\$1,397 million, indicating increased product cross-selling to customers. It represented 52.2% of total other operating income. Card services income decreased by 11.6% to HK\$258 million, mainly because of the outbreak of SARS in the second quarter of 2003.

Operating expenses increased by HK\$5 million, or 0.3%, to HK\$1,821 million. Compared with the second half of 2002, however, operating expenses fell by 9.7%.

Staff costs decreased by 1.4% from the first half of 2002, due to the reduction of 147 staff members on a full-time equivalent basis. The total staff number of 7,174 was a decrease of 874 from its high point in 1997.

The net charge for bad and doubtful debts amounted to HK\$456 million, an increase of 62.3%.

New and additional specific provisions rose by 26.1% to HK\$666 million, reflecting the fall in value of property collateral and higher provisions on residential mortgages and credit card advances due to the rise in unemployment and personal bankruptcies. Releases and recoveries were reduced by 17.4% to HK\$204 million, reflecting the decrease in recoveries from residential mortgages and taxi loans.

The ratio of total provisions as a percentage of gross advances to customers fell to 1.17% at 30 June 2003, compared with 1.28% at the end of 2002. Specific provisions decreased by 0.10 percentage point to 0.69%, while general provisions were reduced by 0.01 percentage point to 0.48%.

Gross non-performing advances (after deduction of interest in suspense) fell by HK\$410 million, or 6.7%, to HK\$5,671 million. The ratio of gross non-performing advances to gross advances to customers further improved to 2.5% from 2.7% at the end of 2002. Specific provisions plus collateral that is conservatively valued amounted to 100% of non-performing advances.

Rescheduled advances to customers increased by HK\$1,127 million, or 61.6%, to HK\$2,958 million at 30 June 2003 and represented 1.3% of gross advances to customers. The increase was mainly due to the debt restructuring of certain corporate customers.

We maintained strong liquidity and remained well-capitalised. The average liquidity ratio for the first half of 2003 was 45.0%, compared with 43.4% for the period a year earlier. The total capital ratio was 14.0% and the tier one capital ratio was 12.3% at 30 June 2003, compared with 14.2% and 11.9% respectively six months earlier.

## Loans and deposits

Hang Seng increased its market share of total deposits and loans for use in Hong Kong in the first half of 2003.

Deposits increased by 1.3% to HK\$419.1 billion, compared with the end of 2002. Funds continued to shift from time deposits to savings and current accounts, reflecting customer preference for liquidity in the prevailing low interest rate environment.

Advances to customers (after deduction of interest in suspense and provisions) recorded growth of HK\$1.6 billion, or 0.7%, to HK\$226.2 billion. Loan demand remained weak in the uncertain economic environment.

Lending to the industrial, commercial and financial sectors grew by 2.7%. Trade finance rose by 13.1%, benefiting from the improvement in external trade.

Advances to individuals decreased by 2.5%. Lending under the Government Home Ownership Scheme (GHOS) continued to decline following the indefinite cessation of the sale of new flats. Residential mortgages and credit card advances fell moderately as a result of the outbreak of SARS.

The average yield on the residential mortgage portfolio, excluding GHOS mortgages and staff loans, fell to 170 basis points below best lending rate for the first half of 2003, before accounting for the effect of cash incentive payments. This compared with 138 basis points and 160 basis points below best lending rate in the first and second halves of 2002 respectively. Cash incentive payments on new mortgage loans of HK\$45 million have been written off against interest income in the first half of 2003, compared with HK\$44 million and HK\$61 million in the first and second halves of 2002 respectively.

Total advances to Mainland-related entities were maintained at HK\$9.7 billion and accounted for 4.3% of total advances at the end of June 2003.

## Lines of business

Personal financial services, the major profit contributor, provided 51.2% of the profit before tax. Commercial banking contributed 11.0% of pre-tax profit, corporate and institutional banking 6.1% and treasury 18.6%. Other businesses, which mainly represent management of shareholders' funds and investments in premises, investment properties and long-term equities, provided 13.1% of pre-tax profit.

Personal financial services recorded growth of 2.2% in profit before tax, compared with the same period in 2002. Net interest income fell by 4.4% because of the further decline in the average mortgage yield and contraction in the GHOS mortgage portfolio.

Other operating income, including wealth management, rose by 30.9%. The contribution from investment and insurance services rose by 37.0% and 37.6% respectively.

Sales of retail investment funds, including the popular Hang Seng Investment Series, increased by 48.8%. A total of 17 investment funds were launched under the Investment Series in the first half of 2003, taking the total to 77 at 30 June 2003. The total included 56 capital-guaranteed funds – the largest group of capital-guaranteed funds in Hong Kong.

Total funds under management by Hang Seng's asset management and private banking business units grew by HK\$7.7 billion, or 18.8%, to HK\$48.3 billion at 30 June 2003.

The Bank's focus on deepening customer relationships through segmentation was strengthened with the launch of Leisure Class. This new service offers comprehensive wealth management and a wide range of tailor-made leisure activities to enhance the lifestyle of retirees and those who are planning to retire.

Commercial banking recorded growth of 13% in profit before tax. The results benefited from the increase in fee income, mainly trade services related, and the substantial release in bad debt provisions. Despite satisfactory growth of 13.7% in customer advances due to improved external trade, net interest income was affected by the compression in lending and deposit spreads.

We increased our customer base among small and medium-sized enterprises (SMEs), partly by reaching out to business associations.

Corporate and institutional banking suffered a decline of 24.2% in profit before tax. The operating result was affected by the compression in corporate lending spread, a reduction in credit facilities income and the absence of substantial releases in specific provisions.

Treasury achieved growth of 6.3% in pre-tax profit. Net interest income rose by 4.4% as more funds were redeployed from interbank placings to capital market investments for enhancement of interest yield, while the fixed rate debt securities portfolio continued to benefit under the low interest rate environment. Dealing income increased by 41.6%, mainly in foreign exchange, reflecting favourable conditions in foreign exchange markets.

### Other business developments

Hang Seng is committed to developing its business in the mainland China market, in particular the rapidly growing Pearl River Delta.

In view of Hong Kong's economic convergence with the Pearl River Delta, we have been strengthening activities in the area, concentrating on Hong Kong-based firms with production facilities there.

The Bank's Guangzhou branch received approval in June from the China Banking Regulatory Commission to operate renminbi services. It will become our second branch, after Shanghai, to offer renminbi services. We have also applied for our Shenzhen branch to offer renminbi services.

The Bank will expand its Mainland network with the opening of a branch in Nanjing and a sub-branch in Puxi, Shanghai.

At the end of June 2003, the number of customers registered for Personal e-Banking services in Hong Kong had grown to about 290,000, an increase of about 14% from six months earlier. The number of internet transactions had risen to 17.7% of total transactions and online share trading to 56.3% of total securities transactions.

We continued to enhance e-Banking services. In July 2003, we launched e-Fund Supermarket at [www.hangseng.com](http://www.hangseng.com) to provide customers with comprehensive one-stop online investment fund services. In June 2003, online Mandatory Provident Fund services were added to Business e-Banking.

Meanwhile, counter transactions fell to 13.9% of total transactions in the first half of 2003 from 16.1% in the same period in 2002, allowing our branches to focus on product sales.

In April, Moody's Investors Service affirmed Hang Seng's long-term local currency deposit rating of Aa3, short-term local currency deposit rating of Prime 1, long-term foreign currency deposit rating of A3 and short-term foreign currency deposit rating of Prime 1. The Bank Financial Strength Rating of B, the highest rating among Moody's rated Hong Kong banks, was also affirmed.

In May, Fitch affirmed Hang Seng's Individual rating of A/B, the highest rating for banks in Asia.

### Corporate social responsibility

We believe that social responsibility goes hand in hand with business success and we support the communities that we serve as a business.

As a good corporate citizen, we contributed a total of HK\$700,000 for SARS-related relief and prevention work and the setting up of scholarship schemes in memory of the two public hospital doctors who died of SARS.

We continued to focus on education, community services and sports development in our philanthropic and sponsorship activities.

The Bank has allocated over 550 scholarships, amounting to about HK\$32 million, for local, mainland China and overseas studies since 1995. With the award to four Hong Kong and Mainland students in 2003, the total number of Hang Seng Scholars benefiting from the Bank's Overseas Scholarship Scheme stands at 32.

The Bank's sponsorship of "Blossom with Music" won the Silver Award in the Arts Development Award – Arts Sponsorship Category, organised by the Arts Development Council. This music-in-education programme has brought enjoyment to over 234,000 students since 1998.

The Bank also seeks to minimise the environmental impact of its business and develop a range of management practices aimed at promoting sustainable development. An Environmental Management Committee, set up in January 2003, oversees the implementation of the Bank's environmental policy.

### Future prospects

In the second half of 2003, the Hong Kong economy will remain difficult. The banking sector will continue to face the challenges of subdued loan demand and narrowing margins.

Hang Seng will build further on its financial soundness, large customer franchise and efficient delivery network to sustain superior performance.

Our focus on higher margin businesses, in particular wealth management and SMEs, will be strengthened to increase non-interest income. We shall also keep widening our product range to meet evolving customer needs.

In our personal financial services, we shall deliver greater value to customers through integrated products and lifestyle banking services. Segmentation and needs-based cross-selling will be emphasised in relationship building.

We are increasing our focus on private banking. Our aim is to become a leading domestic player in terms of assets under management, client base and profitability.

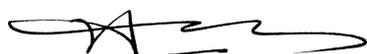
In our commercial banking business, we aim to provide total business solutions to customers and to grow market share in trade finance.

To serve the trade finance needs of customers who have offshore operations in Macau, we are planning to open a branch there, subject to regulatory approval.

We intend to expand in the Mainland market, particularly in the rapidly growing Pearl River Delta. Following the signing of the Closer Economic Partnership Arrangement (CEPA) between Hong Kong and the Mainland, we shall reinforce integrated cross-boundary services for commercial customers.

We shall continue to grow our Mainland network with more branches in major cities and through internet banking services, which will be further enhanced in the second half of 2003.

Through the years, Hang Seng has developed a trusted brand and a leading position in the Hong Kong banking sector. We shall continue to build on our financial and operating strengths to create value for shareholders, to satisfy customer needs and to enhance our market position.



**Vincent H C Cheng**

*Vice-Chairman and Chief Executive*

Hong Kong, 4 August 2003