In the first half of 2004, Hang Seng's performance benefited from the economic recovery and the Bank's strong asset quality. The narrow interest margins in the low interest rate environment, however, remained a challenge.

Operating profit before provisions rose by HK$23 million, or 0.4%, to HK$6,096 million.

Net interest income decreased by HK$509 million, or 9.8%. However, our continuing focus on wealth management resulted in a strong rise in other operating income, which went up by HK$688 million, or 25.7%, enabling us to report an increase of 2.3% in total operating income over the comparable period last year.

Other operating income, which contributed 41.6% of total operating income, benefited from the active stock market and positive investor sentiment. Revenues increased from brokerage, retail fund distribution and funds under management as well as cross-sales of new life insurance products.

Operating profit after provisions rose by 22.1%, benefiting from a release of HK$763 million in provisions for bad and doubtful debts, compared with a charge of HK$456 million for the same period last year. The total release comprised a net release in specific provisions of HK$65 million and a release of HK$698 million in general provisions, reflecting the improvement in Hang Seng's loan loss history.

Profit before tax amounted to HK$7,323 million, which was HK$1,395 million, or 23.5%, higher than the first half of 2003, after accounting for the surplus on property revaluation of HK$119 million.

Attributable profit rose by HK$1,223 million, or 24.4%. Excluding the impact of the release in general provisions and the related deferred taxation, attributable profit for the first half of 2004 increased by HK$647 million, or 12.9%, over the first half of 2003.

In comparison with the second half of 2003, other operating income grew by 33.2%, mainly attributable to the substantial growth of 221.4% in income from retail investment products and funds under management, a 24.5% rise in revenues from securities/stockbroking and 25.1% in dealing profits.

The cost:income ratio for the first half of 2004 was 24.5%, 1.4 percentage points higher than the same period last year but 3.3 percentage points lower than the second half of 2003.

Financial highlights

Net interest income, at HK$4,711 million, was affected by the exceptionally low Hong Kong dollar interest rates in the first half of the year, which reduced deposit spreads, and the fierce competition in the mortgage markets which negatively impacted margins.

Average interest-earning assets rose by HK$33.1 billion, or 7.6%. Net interest margin narrowed by 39 basis points to 2.02% with a reduction in the net interest spread of 38 basis points to 1.95%, mainly due to the fall in the average mortgage portfolio yield and compression in spreads on time deposits, HIBOR based lending and debt securities. Contribution from net free funds fell HK$23 million, or 1 basis point, to 0.07% due to the fall in interest rates.

Outweighing the drop in net interest income, other operating income totalled HK$3,362 million, compared with HK$2,674 million for the first half of 2003. Net fees and commissions rose by 26.5%, contributed by encouraging growth of 137.9% in securities broking and related services, 20.1% in retail investment products and funds under management, 12.4% in trade services and 8.4% in cards.

Dealing profits grew by 54.6%, mainly in foreign exchange income, which included the profit on currency-linked investment products provided to customers. Insurance commissions and underwriting profit together grew by 17.8% due to strong growth in life insurance premiums.

Life insurance grew significantly in both market share and profitability, reflecting the success of an innovative range of products designed to give extended protection but with a shorter premium payment period.

Operating expenses increased by HK$156 million, or 8.6%, to HK$1,977 million. Staff costs increased by HK$38 million, or 3.8%, mainly due to the increase in headcount and the variable staff bonuses. Depreciation reduced by HK$18 million, or 10.5%, while premises and equipment expenses rose by HK$39 million, or 10.6%, due mostly to the increase in IT expenditure. Other operating expenses rose by HK$97 million, or 34.3%, mainly in marketing expenditure and processing costs. Marketing expenditure increased following the low level of marketing activity in the first half of 2003 due to SARS.

Full-time equivalent staff increased by 195 during the first half of 2004 to 7,475, mainly to support the expansion of our personal financial services and Mainland branches.

Provisions for bad and doubtful debts showed a net release of HK$763 million compared with a net charge of HK$456 million for the same period last year. There was a net release in specific provisions of HK$65 million, compared with net charges of HK$462 million and HK$336 million for the first and second halves of 2003. The net release reflected the reduction of credit charge-offs, and increase in recoveries from mortgages and commercial customers. This was in line with the benign credit conditions during the first half of the year as the economic recovery continued to take shape, with falling unemployment, reduced levels of bankruptcies, and rising property prices. Accordingly, there was a release of HK$698 million in general provisions following a review of the historical loss experience.

The more buoyant economy contributed to the further improvement in the ratio of gross non-performing advances to gross advances to customers, which was 1.6% at the end of June 2004 compared with 2.3% at the end of December 2003. Overdue advances dropped by 37.7% to HK$2,060 million, reflecting the substantial improvement in delinquent mortgage, overdraft and corporate accounts.

The liquidity ratio improved from 45.0% to 48.1%; the total capital ratio stood at 12.8% (13.2% at 31 December 2003); and the tier 1 capital ratio was 11.4% (11.3% at 31 December 2003).

Loans and deposits

Total advances to customers (net of provisions) had grown by 7.5% to HK$246.8 billion at 30 June 2004.

Lending to the industrial, commercial and financial sectors grew by HK$7,247 million, or 7.8%, during the first half of 2004. Following the recovery of the economy, double-digit growth was recorded in the sectors of property investment, wholesale and retail trade, manufacturing, transportation and others.

Trade finance advances recorded an encouraging growth of HK$4,485 million, or 39.6%, in line with the strong growth in international trade flows and the expansion of our commercial banking and trade services.

Lending to individuals rose by HK$805 million, or 0.7%. Excluding the fall of HK$2,121 million in mortgages under the suspended Government Home Ownership Scheme (GHOS), the growth in individual lending was 3.2%. Credit card advances and other lending to individuals, mainly overdraft, tax and personal loans, together rose by HK$1,734 million, or 15.5%. Residential mortgages increased by HK$1,192 million, or 1.5%, in an active and intensely competitive market environment.

Gross advances for use outside Hong Kong rose by HK$3,549 million, or 53.0%, mainly as a result of the encouraging growth of 62.4% in the loan portfolios of our Mainland branches to HK$6,162 million at 30 June 2004.

Current, savings and other deposit accounts, including certificates of deposit in issue, decreased by HK$11.5 billion, or 2.6%, to HK$428.4 billion, compared with HK$439.9 billion at 31 December 2003. Customer deposit accounts fell by HK$13.5 billion as customers continued to shift funds to other financial investments in the low interest rate environment.

Lines of business

Personal Financial Services (PFS) reported a growth of 16.8% in profit before tax, benefiting from the reduction of 85.1% in specific provisions and the release in general provisions. Net interest income fell by 12.3%, mainly due to the significant reduction in spreads on time deposits owing to the exceptionally low Hong Kong dollar interest rate environment and further declines in mortgage portfolio yield under severe market competition.

Other operating income rose by 25.4%, driven by the continuous expansion in the wealth management business.

Investment services income rose by 33.3%, as a result of increased securities brokerage and retail investment product sales. Total funds under management have grown by HK$12.6 billion, or 21.7%, since the end of last year, reflecting further expansion of the Hang Seng Investment Series and the growth in the private banking business. Insurance income grew by 26.3%, mainly due to the success of the life insurance business, which recorded impressive growth of 115.7% in annualised premiums and 27.7% in underwriting income.

PFS customer advances recorded a growth of 1.6%. Private sector residential mortgages rose by 1.8% but those under the suspended GHOS fell by 7.0%. During the period, PFS continued to expand its consumer lending portfolio, with credit card and personal lending recording growth of 16.8%. Credit cards in issue rose by 12.5% to 1,093,000 during the first half of 2004 with card spending increasing by 58.1% over the same period last year, benefiting from improved consumer spending and the introduction of new e-payment services.

Commercial Banking reported growth of 101.5% in profit before tax. Led by rising exports and consumer spending, the economy picked up in the first half of 2004. Commercial Banking in the Mainland also registered growth in the customer base, loans and trade services. Underpinned by the increase in customer advances and the expansion of trade services, net interest income and other operating income grew by 24.8% and 12.7% respectively. The operating result also reflected the release in provisions for bad and doubtful debts.

Corporate and Institutional Banking recorded growth of 18.1% in profit before tax, mainly due to the release in general provisions, reflecting further improvement in the quality of the CIB loan portfolios.

Treasury reported growth of 20.8% in profit before tax. Net interest income rose by 11.3%, largely contributed by the effective positioning of the accrual portfolios in the low interest rate environment. Other operating income increased by 73.2%, mainly contributed by foreign exchange income from currency-linked investment products provided to customers.

Other business showed a decline of 9.4% in profit before tax. There was a substantial reduction in return on shareholders' funds due to the exceptionally low Hong Kong dollar interest rates. The shortfall was partly made up by the increase in dividend income and the surplus on revaluation of properties.

Business expansion

The Mainland continues to be a major focus of our expansion efforts, particularly in the Pearl River Delta and major coastal cities.

Our Shenzhen branch began offering renminbi (RMB) services to foreign passport holders and residents of Hong Kong, Macau and Taiwan, as well as foreign-invested enterprises. In late June, we received approval for the Fuzhou branch to offer these services later in the year. Our Shanghai, Guangzhou and Shenzhen branches received approval to offer RMB banking services to domestic companies on the Mainland.

Approval was also received to open two sub-branches: one in Shanghai and one in Shenzhen. With the addition of these sub-branches, our network will comprise five branches, three sub-branches and two representative offices in seven cities.

In Macau, we opened our first branch to meet the operational needs of trade finance customers.

In June the Bank was approved by the China State Administration of Foreign Exchange (SAFE) for an investment quota of US$50 million to invest in the Mainland securities market after it was granted a QFII Securities investment business permit by the China Securities Regulatory Commission. This enables Hang Seng — and our Hong Kong and overseas customers — to invest directly in Mainland A share securities.

In the first half of 2004, the Bank launched Living in HK, a service targeting new immigrants from the Mainland. Hang Seng also launched RMB services at its Hong Kong branches, including deposits, exchange and remittances.

Other developments included the extension of e-Banking services. An Online Warrant Supermarket was introduced in June providing up-to-date information on all covered warrants in Hong Kong, and a new Lifestyle Banking website was launched providing customers with updated information on the Bank's wealth management services as well as privileges and news on lifestyle activities.

Counter transactions dropped to 12.8% at the end of June, with e-Banking accounting for 24.3% of all transactions compared with 23.1% in December 2003. The number of e-Banking customers at Hang Seng now exceeds 380,000.

The Bank was named the "Best Domestic Commercial Bank in Hong Kong in 2003" by *The Asset* for the fourth consecutive year and was awarded the Reader's Digest "SuperBrands Gold Award" in the Banking category.

During the first half of 2004, Moody's Investors Service maintained Hang Seng's long-term foreign currency deposit rating at A1; long-term local currency deposit rating at Aa3; short-term foreign currency deposit rating at Prime 1; short-term local currency deposit rating at Prime 1; and the Bank Financial Strength Rating at B, the highest among all Moody's rated Hong Kong banks.

Fitch maintained its individual rating of A/B, the highest among banks in Asia.

Corporate social responsibility

Hang Seng believes in practicing good corporate citizenship and supporting the communities in which it operates.

Education is a special focus of the Bank's philanthropic activities. Hang Seng has allocated over HK$34 million to local, mainland China and overseas scholarship schemes, benefiting around 680 students since the launch of the programme in 1995. Four scholarships were awarded in February to four outstanding medical students of the Chinese University of Hong Kong and the University of Hong Kong. Another four students from Hong Kong and two from the Mainland were presented with overseas scholarships in July.

Hang Seng's commitment to promoting table tennis was extended for another three years in April with an additional pledge of over HK$3.7 million to the Hang Seng Table Tennis Academy. This programme has benefited about 45,000 table tennis enthusiasts in the past three years since the Academy was established.

The Bank also develops music appreciation in children through the "Hang Seng Bank — Blossom with Music" programme. Presented in association with the Hong Kong Philharmonic Orchestra, the programme has enriched about 300,000 students since its launch in 1998.

As an environmentally conscious business, Hang Seng has established an environmental management system with the objective of promoting sustainable development. This system enables the Bank to enhance its environmental practices.

In recognition of its socially responsible practices, the Bank has been a constituent company on the FTSE4Good Global Index since 2002.

Future prospects

In the next six months we expect the economic recovery to continue, albeit at a slower pace. Intense competition in the banking sector and the depressed interest rate margin will remain challenging factors for Hang Seng.

Our expansion on the Mainland will be an ongoing and integral part of our business focus. Following the acquisition of 15.98% of Industrial Bank Co. Ltd., we will explore opportunities for offering credit card and unsecured personal loan businesses when the relevant regulations permit.

In Hong Kong the Memorandum of Understanding we signed with China Unionpay in April will enable us to launch RMB credit card services for Hong Kong residents later this year.

We will also concentrate on deepening customer relationships by widening our wealth management product range to meet the demand for more sophisticated investment and life insurance products. Additionally, we will develop innovative e-Banking solutions that provide greater convenience and access to our services.

In order to expand our fast-growing SME business, we will offer enhanced trade finance services and one-stop financial solutions, and increase our customer base.

We are well positioned to capitalise on the improving economy in Hong Kong. To meet the challenges that lie ahead, we will take advantage of our strengths in customer service, our financial soundness, operational efficiency and the respected brand that we have established. We shall continue to create value for our shareholders and provide enhanced services for our customers.

Vincent H C Cheng
Vice-Chairman and Chief Executive
Hong Kong, 2 August 2004