

Chief Executive's Report

The economy of Hong Kong has recorded strong growth and market sentiment has been improving significantly in the first half of 2004. On the back of this recovery and capitalising on its own stronger foundations, the Group was able to achieve satisfactory performance in most of its core businesses while sustaining the growth of its attributable profit.

Performance Highlights

For the six months ended 30 June 2004, the Group delivered an attributable profit of HK\$5,581 million to our shareholders, up HK\$2,569 million or 85.29% over the first half of last year. This was driven mainly by a strong growth in net fees and commission income, disciplined cost and significant write-back of provisions. Return on average total assets and return on average shareholders' funds rose by 0.66 and 7.63 percentage points to reach 1.48% and 18.19% respectively.

Our net fees and commission income grew HK\$334 million or 24.26%, thanks to a remarkable increase of HK\$460 million or 134% in fees from wealth management business. Non-interest income as a percentage of total operating income increased to 31.33% from 25.49%.

We continued to exercise disciplined cost control while increasing investment in business development and technology. Operating expenses decreased by 1.11% to HK\$2,667 million. The cost to income ratio was maintained at a low level.

Benefiting from the recovery in local economy, the quality of the Group's retail and corporate loan portfolios improved considerably. The Group recorded a write-back of provision of HK\$1,240 million due to strong recoveries, higher collateral value and lower NPL formation. Our NPL ratio fell to 4.11%, exceeding our target and bringing us nearer to the market average.

However, persistently low interest rates and keen market competition during the period pushed net interest income down by HK\$1,075 million to HK\$5,509 million. Net interest margin narrowed by 0.33 percentage point to 1.56%. This was mainly attributable to a decline in yields from interbank placements, loans and debt securities.

The Group's financial position remained sound and solid. The capital adequacy ratio increased to 16.52% at 30 June 2004 and the liquidity position remained strong.

Business Review

In the first half of 2004, we continued to implement our business development strategy that focuses on high margin, high growth, product innovation and enhancement as well as improvement in service quality.

Retail banking

The Group's retail banking business performed very well under improved market conditions. We achieved strong growth in the wealth management business, including stock brokerage, distribution of life insurance products, investment funds and retail bonds.

At the same time, we have been active in developing the high-margin consumer credit business. In this regard, the performance of the credit card segment has been remarkable. During the interim period, we achieved high growth in terms of card issuance, cardholder spending and merchant acquiring business. We also won several awards from Visa International and MasterCard International for outstanding performance.

Since the introduction of personal RMB banking services in Hong Kong in February this year, the Group has been the clearing bank as well as the leading service provider in RMB business. The Group has also been the pioneer of RMB credit card services in Hong Kong. Launched in April this year, our RMB credit cards have met with very encouraging response from customers.

Treasury

Insofar as treasury business is concerned, our strategic priority has been the development of a customer-driven platform. Leveraging our enlarged customer base, we succeeded in boosting the business volume and income from both foreign exchange and bullion trading.

Chief Executive's Report (continued)

Business Review (continued)

Mortgage

Capitalising on the gradual recovery of the residential property market in the first half of the year, we have been growing our market share in the mortgage business and the size of our mortgage loan portfolio. By end-June 2004, the Group's mortgage lending balance increased by 5%, which outperformed the average market growth rate of 0.4% by a wide margin.

Corporate banking

On the corporate banking front, the Group has been able to maintain a leading position in arranging syndicated loans in the local market despite a diminished portfolio. We continue to emphasise on improving the quality of corporate credit portfolio and curbing bad debt formation. The lending to the industrial, commercial and financial sectors dropped by 5.3% as a result of large collections and write-offs. While the lending to local corporate including trade finance, and loans for use outside Hong Kong dropped by 2.2% from end-2003, the balance net of classified loans increased by 0.4%.

The Group's overseas lending, especially the loan portfolio of Mainland branches, continued to expand in volume and improve in quality. At the same time, we have strengthened our capabilities in trade finance and succeeded in upgrading our service quality. In May we launched CBS Online, a key channel for servicing our corporate customers and thus enhancing the competitive edge of our corporate banking business as a whole.

Mainland branches and China-related business

Our Mainland branches continued to deliver better results in the first half of 2004. Total advances to customers rose by 46% and operating profit before provisions increased by 28%. During this period, we stepped up our effort in enhancing banking services offered through our Mainland branches. Two new electronic distribution channels were introduced, namely, iT's Online Banking and Telephone Banking. Meanwhile, our Shenzhen branch and Shanghai branch obtained approval to offer RMB services to domestic companies. We are in the process of refining our business model in the Mainland, with a view to increasing the contribution of the China-related business to the Group and better equipping ourselves for capturing cross-selling opportunities.

Channels, technology and operation

The Group's ongoing project of consolidating and renovating the branches to maximise utilisation and cost efficiency proceeded as planned. Our branch rationalisation programme started in 2001 is nearing completion. In the first six months of 2004, two branches were closed. As at 30 June 2004, the number of branches stood at 302, compared to 304 at end-2003. Our next focus is to strengthen the selling and servicing capability of the branches.

Investment in the internet banking channel continued in accordance with our plan. The enhancement of the Group's e-channels has resulted in considerable growth in the number of iT's Banking customers.

Prospects and business strategies

In the remainder of 2004, we will continue to focus on developing our franchise in retail banking, particularly wealth management, growing trade finance and SME business, maintaining the momentum in China-related business and fostering our leadership in personal RMB business.

In retail banking, we are launching a new wealth management platform with a greater emphasis on customisation and product development. We will further upgrade our service by offering one-stop financial planning services to cater for our customers' diverse needs. We are also actively engaged in the development of high-margin consumer loan products and marketing programmes to boost the growth of our credit card business. In addition, we aim to solidify our leading market positions in residential mortgage by offering competitive and flexible mortgage products and schemes.

As regards to corporate banking, we will continue to focus on improving the credit quality of our corporate loan portfolio. We have put in place a new marketing structure which will stress relationship management, and will provide a platform to develop and sell high margin loan products. The new relationship management concept will enable us to exploit the untapped potential of our large existing customer base, and also allow us to effectively compete in the SME market. We are optimistic that this new system will serve the dual purpose of generating new business and facilitate the distribution of our other services and products.

Chief Executive's Report (continued)

Prospects and business strategies (continued)

China business is another key focus of our strategies. We will strive to grow our Mainland branch business in order to maintain the momentum we have built up in the first half. We will further solidify our position in syndicated lending while expanding business cooperation with the Bank of China. Our newly refined China business model is expected to facilitate the business development by enhancing cross-selling.

With our capabilities and experience in personal RMB banking services, we are highly confident of maintaining our market leadership. This segment of our business is expected to see stable growth.

Corporate development

As mentioned by the Chairman, our management structure has been and will be further strengthened so that we are better equipped for long-term growth and development and for coping with new challenges and opportunities.

We launched our human resources reform programme in early July. The package of reforms that we are implementing ensures that our employees have better career prospects, which is essential for delivering superior value to our customers and shareholders.

Issue management

The Management is very much concerned about the Mainland judicial authorities' investigation which, as we were confirmed by the Bank of China, is in connection with some activities prior to our IPO. Although this issue has drawn immediate criticisms on the Group, the Management has been reacting quickly and sensibly together with the Board to manage it and ensure that there is no adverse impact on our image and reputation in the long term.

In fact, under the Board's guidance, our corporate governance, risk management and internal control systems have greatly improved after the merger and IPO. We are also committed to ensuring that this evolutionary process will never stop. With stronger management structure and systems, we are now better able to avoid irregularities of the past and assure the market of our determination and capability in becoming customers' premier bank wherever we operate.

In concluding, I wish to thank the Board for their guidance and thank all my colleagues for their hard work. I would also like to extend my appreciation to our customers and shareholders for their continued support.



HE Guangbei

Vice Chairman and Chief Executive
Hong Kong, 19 August 2004