FROM EXCEEDING OUR TARGET OF DOUBLING SHAREHOLDER VALUE IN 1999 TO 2003, TO ACHIEVING RECORD RESULTS IN 2004...

SHAREHOLDER RETURN

OUR RETURN ON EQUITY DEMONSTRATES THE EARNINGS CAPABILITY OF HANG SENG FOR SHAREHOLDERS.

FINANCIAL PERFORMANCE

Profit and loss account

Summary of financial performance (HK$m)	2004	2003
Operating profit before provisions	**11,830**	11,475
Profit on ordinary activities before tax	**13,367**	11,137
Profit attributable to shareholders	**11,395**	9,539
Earnings per share (HK$)	**5.96**	4.99

Hang Seng Bank Limited (the Bank) and its subsidiary and associated companies (Hang Seng) reported a profit attributable to shareholders of HK$11,395 million for 2004, representing growth of 19.5 per cent compared with 2003. Earnings per share of HK$5.96 was 19.4 per cent higher than 2003.

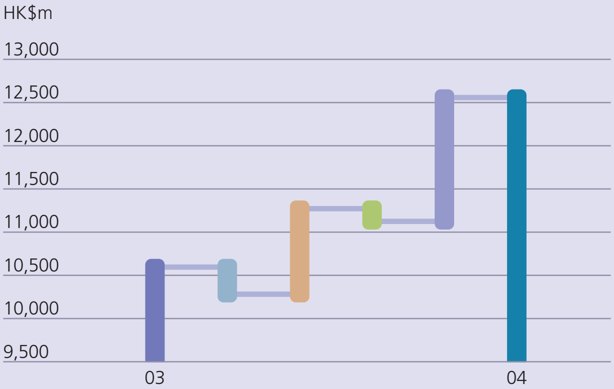
Operating profit before provisions rose by HK$355 million, or 3.1 per cent, to HK$11,830 million. The 22.4 per cent growth in other operating income outweighed a 4.8 per cent fall in net interest income and an 8.2 per cent rise in operating expenses. Wealth management businesses in particular performed strongly, with income growth of 35.1 per cent reflecting the strength of securities services, retail investment product sales and private banking. Wealth management income also benefited from the active stock market and positive investor sentiment. Life insurance made further advances in market share and profitability as the range of products providing protection and investment benefits was extended. Trade services and credit cards also performed well in business volume and fees and commissions. Dealing profits recorded strong growth from trading results, as well as the provision of corporate treasury services and the packaging of structured investment products. Net interest income fell despite the growth in average interest earning assets and customer advances, reflecting the exceptionally low HK dollar interest rates throughout the year that significantly reduced deposit spreads. Loan margins, in particular mortgages and corporate lending, were further squeezed amidst fierce market competition and ample market liquidity.

Operating profit after provisions rose 18.4 per cent after accounting for the release of HK$814 million in provisions for bad and doubtful debts, compared with a charge of HK$792 million last year. Specific provisions showed a net release of HK$2 million, compared with a net charge of HK$798 million last year. This was the combined effect of lower new and additional charges, and higher releases and recoveries from doubtful accounts. Credit card losses reduced significantly, as bankruptcy and unemployment rates continued to fall. There was a net release of provisions in respect of mortgages, reflecting the improvement in delinquency, higher recoveries from disposal of repossessed properties and substantial improvements in the negative equity position. This was the result of the sharp rally in property prices, with strong demand in particular in the primary sector, reflecting an improved debt servicing capability in the improving economic environment. Corporate and commercial banking accounts also showed a net release in provisions with substantially lower new charges as the financial position of corporate customers continued to improve, in line with the strong growth in the local economy. A total of HK$812 million was released from general provisions during the year in light of historical loss experience and the improving credit environment.

Profit before tax amounted to HK$13,367 million, which was HK$2,230 million, or 20.0 per cent, higher than 2003, after accounting for the surplus on property revaluation and the share of profits from associated companies. The increase in the share of associated companies' profit was attributable to Industrial Bank Co., Ltd, in which the bank acquired an interest of 15.98 per cent in May 2004.

Attributable profit, after taxation and minority interests, rose by HK$1,856 million, or 19.5 per cent. Excluding the impact of the release in general provisions and the related deferred taxation, attributable profit for 2004 increased by HK$1,191 million, or 12.5 per cent, over 2003.

Operating Profit Analysis



2003 Operating Profit	10,683
Changes due to:	
Net Interest Income	(489)
Other Operating Income	1,165
Operating Expenses	(321)
Provisions for Bad and Doubtful Debts	1,606
2004 Operating Profit	12,644

Total Operating Income

Economic profit

Economic profit is calculated from profit after tax, adjusted for non-cash items, and takes into account the cost of capital invested by Hang Seng's shareholders. For the year 2004, economic profit was HK$7,297 million, an increase of HK$2,296 million, or 45.9 per cent, over last year. This was attributable to the growth of HK$1,637 million in profit after tax (adjusted for non-cash items) and the reduction of HK$659 million in cost of capital, following management's decision to revise the capital cost from 15.0 per cent to 11.6 per cent to reflect changes in long-term interest rates and equity risk premia. The trend of economic profits in the analysis indicates that Hang Seng continues to create value for its shareholders.

Economic profit (HK$m)	**2004**	**%**	2003	%
Average invested capital	**34,494**		31,021	
Return on invested capital*	**11,286**	**32.7**	9,649	31.1
Cost of capital	**(3,989)**	**(11.6)**	(4,648)	(15.0)
Economic profit	**7,297**	**21.1**	5,001	16.1

* Return on invested capital represents profit after tax adjusted for non-cash items.

Net interest income

Net interest income (HK$m)	**2004**	2003
Interest income	**12,471**	12,846
Interest expense	**(2,781)**	(2,667)
Net interest income	**9,690**	10,179
Average interest-earning assets	**474,219**	446,978
Gross interest yield (% p.a.)	**2.63**	2.87
Net interest spread (% p.a.)	**1.97**	2.21
Net interest margin (% p.a.)	**2.04**	2.28

Net interest income decreased by HK$489 million, or 4.8 per cent, compared with 2003 although average interest-earning assets grew by HK$27.2 billion, or 6.1 per cent. Net interest margin narrowed by 24 basis points to 2.04 per cent with a reduction in net interest spread of 24 basis points to 1.97 per cent. Contribution from net free funds remained at the same level of 0.07 per cent as last year.

Spreads on HK dollar deposits fell by 7 basis points, or HK$332 million, as in the low interest rate environment, the Bank was unable to reduce deposit rates paid to customers. With abundant market liquidity there was also fierce market competition in the mortgage sector, with a consequent reduction in portfolio yields and an increase in incentive payments. The surplus liquidity also depressed corporate lending margins which fell by 6 basis points. The average spread of the securities portfolio fell as higher yielding papers matured and were replaced at lower yields.

The negative impact of the above on net interest income and net interest margin was mitigated by the growth in average interest earning assets of 6.1 per cent and a change in the asset mix as the bank sought diversification of the loan portfolio to higher yielding card and personal advances, trade finance and SME loans. Investment in debt securities increased by 20.1 per cent as funds were re-deployed from short-term interbank placings to debt securities for yield enhancement.

The impact of the individual factors on net interest income and net interest margin is analysed below:

	(HK$m) Net interest income	(Basis points) Net interest margin
Repricing of higher yielding debt securities	(474)	(10)
Reduction in deposit spread	(332)	(7)
Fall in mortgages portfolio yield	(285)	(6)
Compression in corporate loan margin	(285)	(6)
Change in average asset mix	238	5
Growth in average interest-earning assets	649	–
	(489)	(24)

The average yield on the residential mortgage portfolio, excluding GHOS mortgages and staff loans, fell to 202 basis points below BLR for 2004, before accounting for the effect of cash incentive payments. This compared with 177 basis points below BLR in 2003. Cash incentive payments on new mortgage loans of HK$157 million have been written off against interest income in 2004, compared with HK$130 million in 2003.

Compared with the first half of 2004, net interest income in the second half of 2004 improved by HK$268 million, or 5.7 per cent, with a 5 basis points increase in net interest margin to 2.07 per cent. Net interest spread increased by 4 basis points to 1.99 per cent and contribution from net free funds rose by 1 basis point to 0.08 per cent. Deposit spreads improved due to higher market interest rates in the second half of the year, which in turn benefited the contribution of net free funds. Growth in customer advances and higher interest recoveries from doubtful accounts also contributed to the increase in net interest income in the second half of the year.

The average balance sheet analysis on page 31 shows the average balances, interest income/expense and average interest rates of individual assets and liabilities in 2004 as compared with 2003.

	Year ended 31 December 2004			Year ended 31 December 2003		
	Average balance HK$m	**Interest income HK$m**	**Yield %**	Average balance HK$m	Interest income HK$m	Yield %
Assets						
Short-term funds and placings with banks	**75,038**	**1,820**	**2.43**	90,811	1,816	2.00
Advances to customers	**243,273**	**6,870**	**2.82**	226,892	7,306	3.22
Debt securities	**155,908**	**3,781**	**2.42**	129,275	3,724	2.88
Total interest-earning assets	**474,219**	**12,471**	**2.63**	446,978	12,846	2.87
Provisions for bad and doubtful debts	**(1,696)**	**–**	**–**	(2,688)	–	–
Non interest-earning assets	**35,848**	**–**	**–**	29,518	–	–
Total assets and interest income	**508,371**	**12,471**	**2.45**	473,808	12,846	2.71

	Average balance HK$m	**Interest expense HK$m**	**Cost %**	Average balance HK$m	Interest expense HK$m	Cost %
Liabilities						
Current, savings and time deposit accounts	**396,815**	**2,265**	**0.57**	385,394	2,249	0.58
Debt securities in issue	**9,857**	**231**	**2.34**	10,893	279	2.56
Deposits from banks	**11,264**	**203**	**1.80**	2,551	31	1.22
Other interest-bearing liabilities	**3,120**	**82**	**2.63**	3,680	108	2.93
Total interest-bearing liabilities	**421,056**	**2,781**	**0.66**	402,518	2,667	0.66
Non-interest bearing current accounts	**27,690**	**–**	**–**	17,177	–	–
Shareholders' funds and other non-interest bearing liabilities	**59,625**	**–**	**–**	54,113	–	–
Total liabilities and interest expenses	**508,371**	**2,781**	**0.55**	473,808	2,667	0.56

Other operating income

Other operating income recorded strong growth of HK$1,165 million, or 22.4 per cent, and contributed 39.6 per cent of total operating income compared with 33.8 per cent in 2003.

Net fees and commissions benefited from private investor sentiment and a buoyant stock market, with net income rising 30.7 per cent, driven by strong growth of 55.1 per cent in securities broking and related services, 50.8 per cent in retail investment products and funds under management, and 6.7 per cent in card services. Trade services rose 14.8 per cent on the back of strong regional trade flows.

Dealing profits grew 27.0 per cent, mainly in foreign exchange income. This was the result of the improvement in proprietary trading, growth in corporate treasury services and the increase in profit on market-linked investment products provided to customers. Insurance commissions and underwriting profit together grew by 15.6 per cent. Life insurance underwriting profit grew by 22.3 per cent following a growth of 43.5 per cent in annualised premium from a wider range of products with enhanced protection and investment returns.

Analysis of income from wealth management businesses included in other operating income

Income from wealth management businesses (HK$m)	**2004**	2003
Investment income		
– retail investment products and funds under management	**1,502**	996
– securities/stockbroking	**560**	361
– margin trading	**66**	55
Total investment income	**2,128**	1,412
Insurance income		
– life (including embedded value)	**1,041**	851
– general and others	**269**	282
Total insurance income	**1,310**	1,133
Total	**3,438**	2,545

Income from wealth management grew strongly by 35.1 per cent to HK$3,438 million, representing 54.0 per cent of total other operating income, boosted by 50.7 per cent growth in investment services income and 22.3 per cent growth in life insurance income.

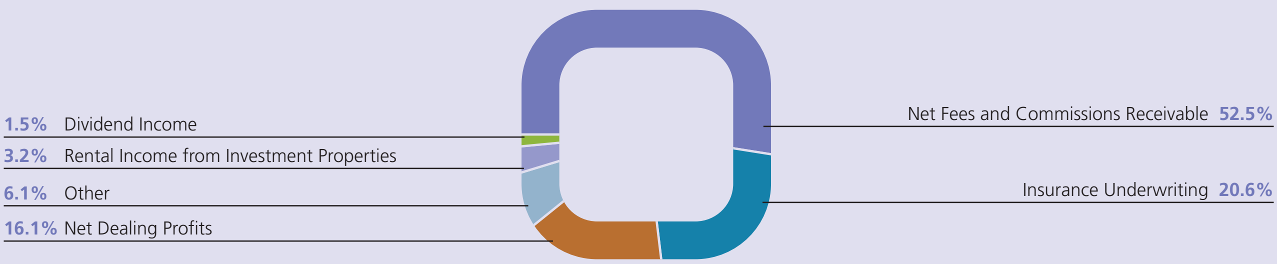
Income from retail investment products and funds under management increased by HK$506 million, or 50.8 per cent, reflecting the Bank's successful product strategy of structuring products to meet specific customer investment needs. This resulted in an increase of 29.8 per cent in the sales of investment funds and structured products, including capital guaranteed funds, unit trust funds and structured instruments linked to the foreign exchange, equity and interest rate markets.

Of particular note was the expansion of the Hang Seng series of investment funds which added 29 funds structured to capture growth potential in the global, Asia, Hong Kong and mainland China equities markets, as well as the commodity and property markets. Private banking business continued to expand in terms of customer base, product range and investment portfolio. Total funds under management, including discretionary and advisory, grew by HK$32.1 billion, or 55.4 per cent, compared with the end of last year.

Income from stockbroking and related securities services rose by 55.1 per cent compared with last year, reflecting the growth in stock market activities. Riding on the buoyant stock market and large IPO issues, promotional campaigns were launched to grow securities accounts and boost trading turnover.

The growth momentum of the life insurance business continued, further penetrating the Bank's large customer base. The launch of new products providing enhanced protection and investment benefits, together with targeted marketing campaigns, boosted annualised premium growth by 43.5 per cent. Underwriting profits (including embedded value) grew 22.3 per cent. General insurance income, however, fell by 4.6 per cent due to higher claims for certain types of insurance.

Other Operating Income for 2004



Operating expenses

Operating expenses increased by HK$321 million, or 8.2 per cent, to HK$4,223 million. Staff costs increased by HK$144 million, or 7.0 per cent, mainly due to the increase in average headcount number and the provision for performance based staff bonuses. Depreciation reduced by HK$12 million, or 3.6 per cent, while premises and equipment expenses rose by HK$48 million, or 5.9 per cent, mainly due to the increase in IT expenditure. Other operating expenses rose by HK$141 million, or 19.5 per cent, mainly in marketing expenditure to support the increased focus on the sale of personal investment products and card services, and processing costs as further activities were outsourced to Group service centres in Guangzhou and Shanghai.

Full-time equivalent staff (FTEs) increased by 262 in 2004, mainly to support the expansion on the Mainland where one new sub-branch was opened in Shanghai during the year and where new licences were obtained to conduct renminbi business in the Shenzhen and Fuzhou branches. Staff increases were also noted in personal financial services, where 80 financial planning managers were added as part of the strategy to develop customer structured solutions. During the year, further back office processes, including cards, phone banking and trade finance with a total 129 FTEs were migrated to Group service centres.

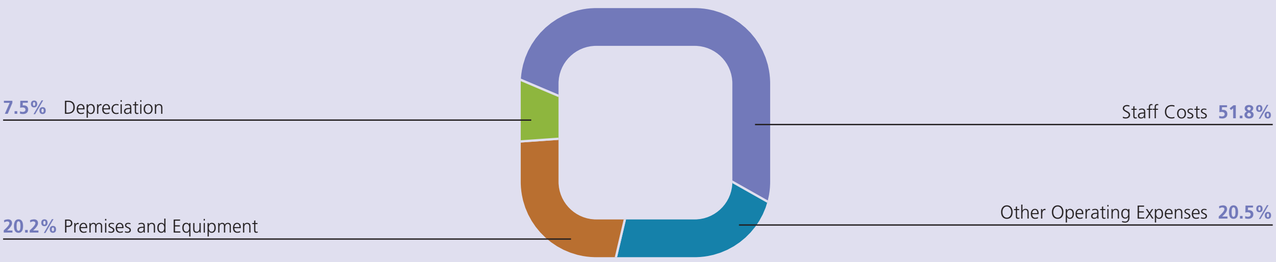
The cost:income ratio in 2004 was 26.3 per cent (25.4 per cent in 2003).

Provisions for bad and doubtful debts

Net charge to profit and loss account (HK$m)	**2004**	2003
Net charge/(release) for bad and doubtful debts		
Specific	**(2)**	798
General	**(812)**	(6)
Total	**(814)**	792
Average gross advances to customers	**244,472**	227,814
Net charge/(release) for bad and doubtful debts as a percentage of average gross advances to customers		
Specific	**–**	0.3%
General	**0.3%**	–
Total	**0.3%**	0.3%

Provisions for bad and doubtful debts showed a net release of HK$814 million compared with a net charge of HK$792 million for last year. Specific provisions showed a net release of HK$2 million against a net charge of HK$798 million for the previous year. This was the combined effect of the reduction of HK$703 million, or 60.2 per cent, in new and additional provisions and an increase of HK$97 million, or 26.3 per cent, in releases and recoveries. Credit card losses reduced significantly, as bankruptcy and unemployment rates continued to fall. There was a net release of mortgage provisions, reflecting lower delinquency levels, reduced negative equity and larger recoveries from disposal of repossessed properties. This reflected the strong rally in property prices and improvement in debt servicing capability

Operating Expenses for 2004



in an improving economic environment. Corporate accounts also showed a net release as new and additional provisions reduced significantly, following the improvement in the financial position of corporate customers. A total of HK$812 million was released from general provisions during the year in light of historical loss experience and the improving credit environment.

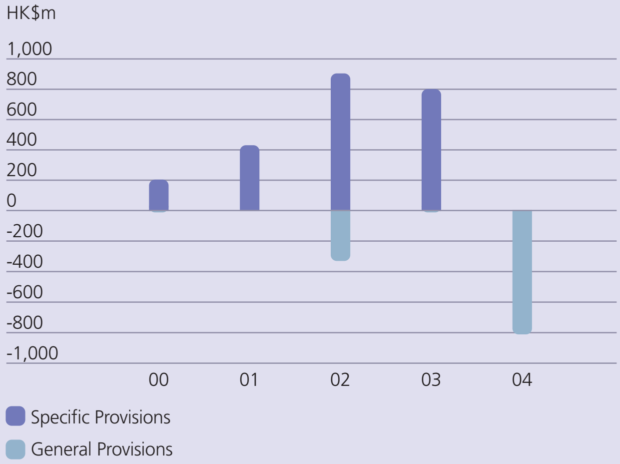
Advances to customers and provisions (HK$m)	2004	2003
Gross advances to customers*	**252,940**	231,999
Specific provisions	**(778)**	(1,432)
General provisions	**(289)**	(1,101)
Advances to customers**	**251,873**	229,466
Gross non-performing advances*	**2,169**	5,243
Non-performing advances* as a percentage of gross advances to customers*	**0.9%**	2.3%
Provisions as a percentage of gross advances to customers*		
Specific provisions	**0.31%**	0.62%
General provisions	**0.11%**	0.48%
Total provisions	**0.42%**	1.10%
Specific provisions as a percentage of gross non-performing advances*	**35.9%**	27.3%

* After deduction of interest in suspense

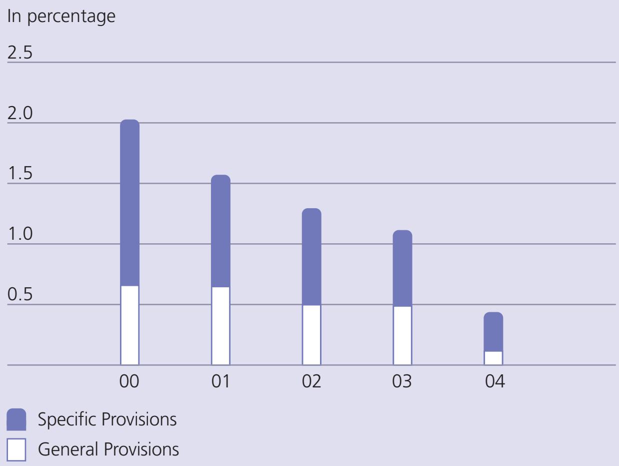
** After deduction of interest in suspense and provisions.

Gross non-performing advances (after deduction of interest in suspense) fell by HK$3,074 million, or 58.6 per cent, to HK$2,169 million, compared with the end of 2003. Irrecoverable balances of HK$761 million were written off against provisions. Corporate non-performing advances reduced significantly by HK$2,332 million, comprising large repayments and upgrades totalling HK$2,500 million and a small amount of HK$168 million from new non-performing accounts. The level of non-performing mortgages and card advances at 31 December 2004 also reduced compared with the prior year, reflecting the improving economic environment, and falling bankruptcy and unemployment levels. The ratio of gross non-performing advances to gross advances to customers further improved to 0.9 per cent from 2.3 per cent at the end of 2003.

Net Charge for Bad and Doubtful Debts



Total Provisions as a Percentage of Gross Advances to Customers



Profit on tangible fixed assets and long-term investments

Profit on disposal of tangible fixed assets and long-term investments fell by HK$29 million, or 6.3 per cent, to HK$432 million, being the net result of the lower profit on disposal of debt securities and equities, and the increase in profit on disposal of investment properties.

Property revaluation

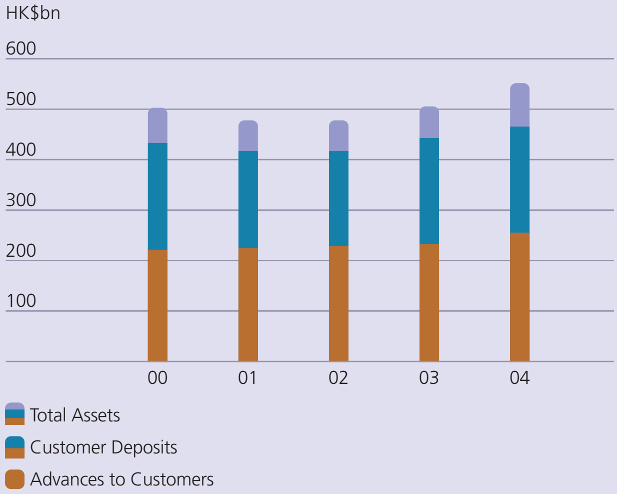
Hang Seng's premises and investment properties were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 September 2004, who confirmed that there had been no material change in valuations at 31 December 2004. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use. The basis of the valuation for investment properties was open market value. The property revaluation has resulted in a surplus of HK$2,224 million, of which HK$1,821 million (net of deferred tax amounting to HK$255 million) has been credited to the Bank's revaluation reserves at 31 December 2004. The remaining amount of HK$148 million has been credited to the profit and loss account, being reversal of the previous revaluation deficit which had arisen when the market value of certain premises fell below depreciated historical cost.

Balance sheet

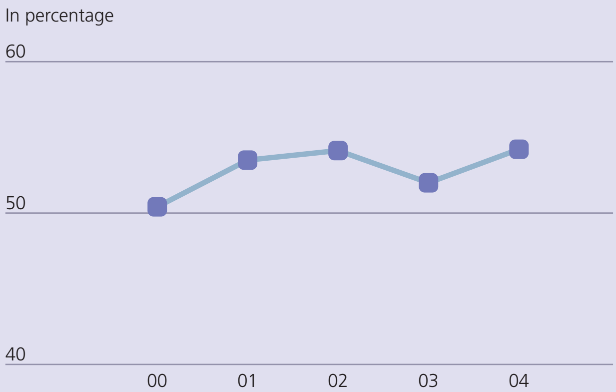
Total assets

Total assets grew HK$45.7 billion, or 9.1 per cent, to HK$548.6 billion at 31 December 2004. Advances to customers recorded an encouraging growth of 9.8 per cent, mainly in advances to the industrial and commercial sectors and trade finance, in line with the strong growth in regional trade flows. Card and personal loans also reported robust growth. Private sector residential mortgages rose slightly in a fiercely competitive market, while mortgages under the suspended Government Home Ownership Scheme (GHOS) continued to fall. Customer deposits, including certificates of deposit, rose by 5.3 per cent against last year-end. The advances to deposits ratio rose to 54.4 per cent at 31 December 2004 compared with 52.2 per cent at 31 December 2003, the effect of a faster paced growth in customer advances than in customer deposits during 2004.

Total Assets, Customer Deposits and Advances to Customers



Advances to Deposits Ratio

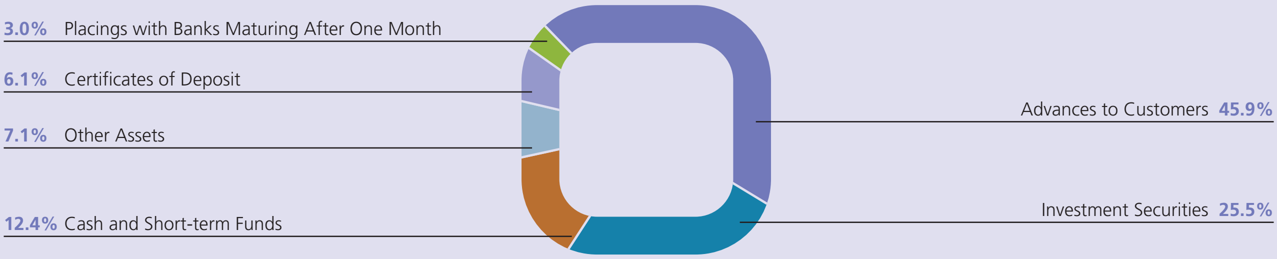


Assets deployment

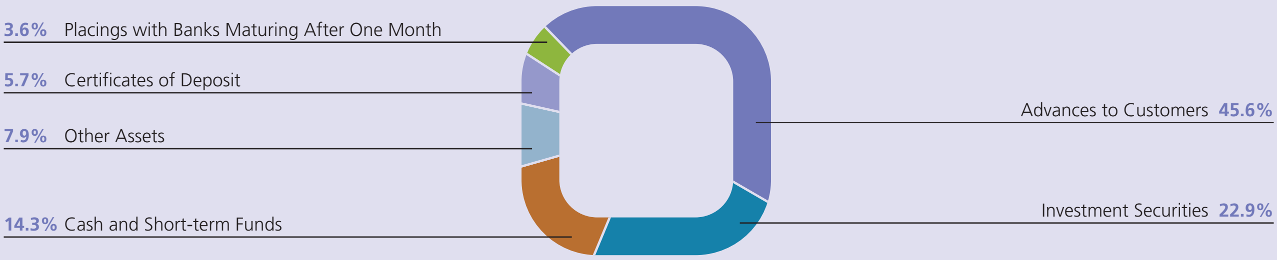
At 31 December (HK$m)	2004	%	2003	%
Cash and short-term funds	**68,198**	**12.4**	71,903	14.3
Placings with banks maturing after one month	**16,231**	**3.0**	18,029	3.6
Certificates of deposit	**33,590**	**6.1**	28,683	5.7
Investment securities	**139,891**	**25.5**	115,113	22.9
Advances to customers	**251,873**	**45.9**	229,466	45.6
Other assets*	**38,842**	**7.1**	39,765	7.9
Total assets	**548,625**	**100.0**	502,959	100.0

* Amounts due from immediate holding company and fellow subsidiary companies are included under other assets.

Assets Deployment for 2004



Assets Deployment for 2003



Investment securities

Investment in held-to-maturity debt securities rose by HK$24.3 billion, or 21.8 per cent, to HK$136.1 billion, with funds re-deployed from interbank placings to enhance net interest yield. Over 95 per cent of the held-to-maturity debt securities will mature within five years. The fair value of the held-to-maturity debt securities amounted to HK$137.0 billion, with an unrealised gain of HK$895 million at 31 December 2004.

Advances to customers

Advances to customers (after deduction of interest in suspense and provisions) recorded a growth of HK$22.4 billion, or 9.8 per cent, to HK$251.9 billion at 31 December 2004.

Lending to the commercial sectors grew by HK$12.4 billion, or 13.4 per cent, during 2004. Property development and investment rose 12.0 per cent. Wholesale and retail trade, manufacturing, and transport and transport equipment reported strong growth of 24.8 per cent, 71.7 per cent and 10.2 per cent respectively. Other, including conglomerates engaged in diversified lines of business, rose by 24.2 per cent.

Trade finance advances recorded an encouraging growth of HK$4.2 billion, or 37.3 per cent. This reflected strong regional trade flows and the success of the Bank in further expanding the commercial banking business by leveraging on strong relationship management, customised trade solutions and e-services.

Lending to individuals fell by HK$1.1 billion, or 0.9 per cent. Excluding the fall of HK$3.9 billion in mortgages under the suspended GHOS, there was a growth of 3.1 per cent in individual lending. Credit card advances grew by 20.3 per cent with an expanded card base and card spending. Other lending to individuals, mainly personal and tax loans, together rose 23.2 per cent, reflecting improved consumer and investor confidence. Residential mortgages rose slightly by 0.5 per cent, in an intensely competitive market environment. Despite the strong growth in new mortgages drawdown, early repayment rose significantly in an active property market.

Gross advances for use outside Hong Kong rose by HK$5.4 billion, or 81.0 per cent, mainly reflecting the encouraging growth in the loan portfolios of Mainland branches.

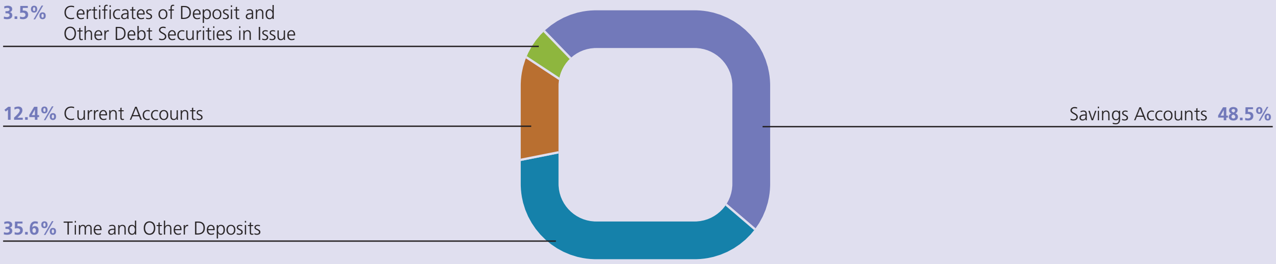
Customer deposits

Current, savings and other deposit accounts, including certificates of deposit and other debt securities in issue, increased by HK$23.5 billion, or 5.3 per cent, to HK$463.4 billion, compared with HK$439.9 billion at 31 December 2003. Customer deposit accounts rose by HK$15.3 billion, or 3.6 per cent. The growth was mainly recorded in savings and current accounts while time deposits fell in the low interest rate environment.

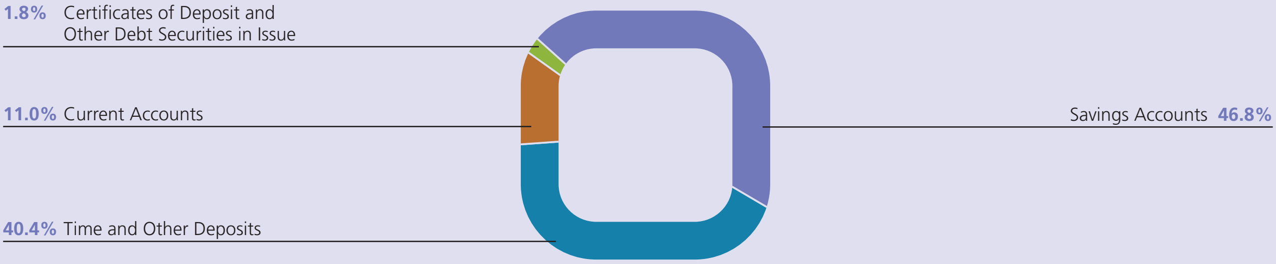
Certificates of deposit and other debt securities in issue rose by HK$8.2 billion, or 102.8 per cent, to HK$16.1 billion.

Structured deposits, certificates of deposit and other instruments with returns linked to currency, interest rate and other market indices, totalling HK$10.7 billion. A growth of 97.2 per cent was recorded as new products were introduced to satisfy customer demand for yield enhancement products in the low interest rate environment.

Customer Deposits for 2004



Customer Deposits for 2003



Shareholders' funds

At 31 December (HK$m)	2004	2003
Share capital	**9,559**	9,559
Retained profits	**21,395**	19,720
Premises and investment properties revaluation reserves	**7,564**	5,813
Long-term equity investment revaluation reserve	**935**	1,009
Capital redemption reserve	**99**	99
	39,552	36,200
Proposed dividends	**3,633**	3,441
Shareholders' funds	**43,185**	39,641
Return on average shareholders' funds (% p.a.)	**27.6**	23.4

Shareholders' funds (excluding proposed dividends) rose by HK$3,352 million, or 9.3 per cent, to HK$39,552 million at 31 December 2004. Retained profits also increased by HK$1,675 million. Premises and investment properties revaluation reserves rose by HK$1,751 million, reflecting the rise in the property market.

The return on average shareholders' funds was 27.6 per cent, compared with 23.4 per cent in 2003, reflecting the growth in attributable profit.

There was no purchase, sale or redemption of the Bank's listed securities by the Bank or any of its subsidiaries in 2004.

Funds under management

Funds under management (HK$m)	2004	2003
At 1 January	**57,861**	40,608
Additions	**70,619**	48,069
Withdrawals	**(43,166)**	(33,526)
Value change	**4,213**	1,855
Exchange adjustments	**405**	855
At 31 December	**89,932**	57,861

Funds under management of HK$89,932 million were HK$32,071 million, or 55.4 per cent, higher than at 31 December 2003, due to expansion of our asset management and private banking businesses.

CAPITAL MANAGEMENT

Capital resources management

Analysis of capital base and risk-weighted assets (HK$m)	2004	2003
Capital base		
Tier 1 capital		
Share capital	**9,559**	9,559
Retained profits	**20,560**	19,084
Capital redemption reserve	**99**	99
Less: goodwill	**(302)**	–
Total	**29,916**	28,742
Tier 2 capital		
Premises and investment properties revaluation reserves	**5,322**	4,096
Long-term equity investment revaluation reserve	**625**	688
General loan provisions	**289**	1,101
Total	**6,236**	5,885
Unconsolidated investments and other deductions	**(2,829)**	(1,283)
Total capital base after deductions	**33,323**	33,344
Risk-weighted assets		
On-balance sheet	**259,429**	234,251
Off-balance sheet	**16,577**	15,047
Total risk-weighted assets	**276,006**	249,298
Total risk-weighted assets adjusted for market risk	**277,029**	253,326
Capital adequacy ratios		
After adjusting for market risk		
Tier 1*	**10.8%**	11.3%
Total*	**12.0%**	13.2%
Before adjusting for market risk		
Tier 1	**10.8%**	11.5%
Total	**12.1%**	13.4%

* The capital ratios take into account market risks in accordance with the relevant Hong Kong Monetary Authority guideline under the Supervisory Policy Manual.

The total capital ratio fell by 1.2 percentage points to 12.0 per cent at 31 December 2004, compared with 13.2 per cent at 31 December 2003. The capital base at 31 December 2004 was maintained at HK$33.3 billion, the same level as at the previous year-end. The rise in premises and investment properties revaluation reserves and retained profits has been offset by the deduction of the cost of investment in Industrial Bank Co., Ltd (IB) and the release of general provisions. Risk-weighted assets adjusted for market risk grew by 9.4 per cent, mainly attributable to the increase in advances to customers and debt securities holdings.

The deduction of goodwill from tier 1 capital base on acquisition of the IB investment, and the growth in risk-weighted assets, caused the tier 1 capital ratio to fall by 50 basis points to 10.8 per cent.

RISK MANAGEMENT

Risk management is an integral part of Hang Seng's business management. The most important types of risks to which Hang Seng is exposed to are credit risk, liquidity risk, market risk and operational risk. Hang Seng's risk management policy is designed to identify and analyse risks, to set appropriate risk limits and to monitor these risks and limits continually by means of reliable and up-to-date management information systems. Hang Seng's risk management policies and major control limits are approved by the Board of Directors and they are monitored and reviewed regularly by the Executive Committee and Audit Committee.

Credit risk

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract. It arises principally from lending, trade finance, treasury and leasing activities. Hang Seng has dedicated standards, policies and procedures in place to control and monitor all such risks.

Credit Risk Management (CRM) is mandated to provide centralised management of credit risk. CRM is headed by the Chief Credit Officer who reports to the Chief Executive and functionally reports to the HSBC Group Credit and Risk. Hang Seng conforms with the HSBC Group standards in establishing its credit policies. The responsibilities of CRM include the following:

- Formulating high level credit policies which are embodied in the Credit Risk Manual as approved by the Board of Directors;

- Establishing and maintaining Hang Seng's Large Credit Exposure Policy. This policy sets controls over the maximum level of Hang Seng's exposure to customers and customer groups and other risk concentrations in an approach which is designed to be more conservative than internationally accepted regulatory standards;

- Issuing Lending Guidelines to provide business units with clear guidance on Hang Seng's attitude towards and appetite for lending to, inter alia, specified market sectors, industries, and products. They are regularly updated and provided to all credit and marketing executives;

- Undertaking an independent review and objective assessment of risk. CRM assesses all commercial non-bank credit facilities over designated limits originated by business units, prior to the facilities being offered to the customer. Renewals and reviews of commercial non-bank facilities over designated levels are also subject to such independent review and assessment;

- Controlling exposures to banks and financial institutions. As full authority has been devolved to HSBC Group Credit and Risk to approve Hang Seng's credit and settlement risk limits to counterparties in the financial and government sectors, Hang Seng CRM co-ordinates with the dedicated unit within Group Credit and Risk which controls and manages these exposures on a global basis using centralised systems and automated processes;

- Controlling cross-border exposures. Similar to the control of exposures to banks and financial institutions, CRM co-ordinates with the dedicated unit within Group Credit and Risk to control country and cross-border risk using centralized systems, through the imposition of country limits with sub-limits by maturity and type of business. Country limits are determined taking into account economic and political factors together with local business knowledge. Transactions with countries deemed to be higher risk are considered on a case-by-case basis;

- Controlling exposure to selected industries. CRM controls Hang Seng's exposure to the shipping and aviation industries, and closely monitors exposures to other industries such as telecommunications, insurance and commercial real estate. Controls and restrictions on new business or the capping of exposure may be introduced where necessary;

- Maintaining facility grading process. Hang Seng adopts HSBC's grading structure which contains seven grades, the first three of which are applied to differing levels of satisfactory risk. Of the four unsatisfactory grades, grades 6 and 7 are non-performing loans. For banks, the grading structure involves ten tiers, six of which cover satisfactory risk. It is the responsibility of the final approving executive to approve the facility grade. Facility grades are subject to frequent review and amendments, where necessary, are required to be undertaken promptly;

- Reporting to senior executives on aspects of the Hang Seng loan portfolio. Credit Committee, Executive Committee, Audit Committee, the Board of Directors and Group Credit and Risk also receive regular reports;

- Managing and directing credit-related systems initiatives; and

- Providing advice and guidance to business units on various credit-related issues.

Special attention is paid to problem loans. Recovery units are established by Hang Seng to provide customers with intensive support in order to maximize recoveries of doubtful debts.

Provisions for bad and doubtful debts are made promptly where necessary and on a prudent and consistent basis with established guidelines. Management regularly performs an assessment of the adequacy of the established provisions for bad and doubtful debts by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics against historical trends and undertaking an assessment of current economic conditions. Management also focuses particularly on the appropriateness of grades assigned to facilities to those borrowers and portfolio segments classified below satisfactory grades.

Liquidity risk

Liquidity management is essential to ensure the Bank has the ability to meet its obligations as they fall due. It is Hang Seng's policy to maintain a strong liquidity position by properly managing the liquidity structure of its assets, liabilities and commitments so that cash flows are appropriately balanced and all funding obligations are comfortably met.

Hang Seng is required to comply with the regulatory liquidity requirement, mainly to maintain the liquidity ratio in accordance with the Fourth Schedule of the Hong Kong Banking Ordinance. Hang Seng's average liquidity ratio in 2004 of 47.2 per cent (46.2 per cent in 2003) which well exceeded the minimum requirement of 25 per cent. In addition, Hang Seng also complies with the HSBC Group's liquidity requirements, which impose stricter criteria for the holding of liquid assets, as prescribed by the HSBC Group Executive Committee.

Hang Seng has established policies and procedures to monitor and control its liquidity position on a daily basis by adopting a cash flow management approach. Hang Seng always maintains a stock of high quality liquid assets to ensure the availability of sufficient cash flow to meet its financial commitments, including customer deposits on maturity and undrawn facilities, over a specified future period. The liquidity management process is monitored by the Asset and Liability Management Committee and is reported to the Executive Committee and the Board of Directors.

As a major source of funding, Hang Seng maintains a diversified and stable customer deposit base, both by maturity and market segment. Hang Seng is active in the local money and capital markets to manage the maturity profile of assets and liabilities and to secure the availability of interbank and wholesale deposits at market rates.

Market risk

Market risk is the risk that foreign exchange rates, interest rates or equity and commodity prices will move and result in profits or losses to Hang Seng. Market risk arises on financial instruments which are valued at current market prices (mark-to-market basis) and those valued at cost plus any accrued interest (accrual basis). Hang Seng's market risk arises from customer-related business and from position taking.

Market risk is managed within risk limits approved by the Board of Directors. Risk limits are set by product and risk type with market liquidity being a principal factor in determining the level of limits set. Limits are set using a combination of risk measurement techniques, including position limits, sensitivity limits, as well as value-at-risk (VAR) limits at a portfolio level.

Hang Seng adopts the risk management policies and risk measurement techniques developed by the HSBC Group. The daily risk monitoring process measures actual risk exposures against approved limits and triggers specific action to ensure the overall market risk is managed within an acceptable level.

VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence. The model used by Hang Seng calculates VAR on a variance/covariance basis, using historical movements in market rates and prices, a 99 per cent confidence level and a 10-day holding period and generally takes account of correlations between different markets and rates. The movement in market prices is calculated by reference to market data for the last two years. Aggregation of VAR from different risk types is based upon the assumption of independence between risk types. In recognition of the inherent limitations of VAR methodology, stress testing is performed to assess the impact of extreme events on market risk exposures.

Hang Seng has obtained approval from the Hong Kong Monetary Authority (HKMA) for the use of its VAR model to calculate market risk for capital adequacy reporting and the HKMA has expressed itself satisfied with Hang Seng's market risk management process.

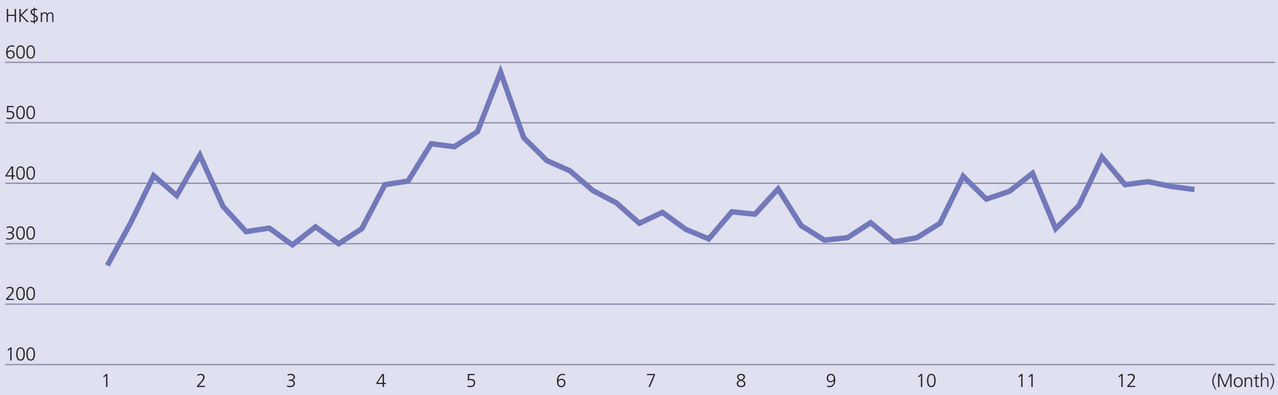
Hang Seng's VAR for all interest rate risk and foreign exchange risk positions and on individual risk portfolios for 2004 and 2003 are shown in the tables on page 41.

VAR (HK$m)	At 31 December 2004	Minimum during the year	Maximum during the year	Average for the year
VAR for all interest rate risk and foreign exchange risk	394	249	605	372
VAR for foreign exchange risk (trading)	3	1	58	33
VAR for interest rate risk				
– trading	4	1	16	4
– accrual	394	244	603	371

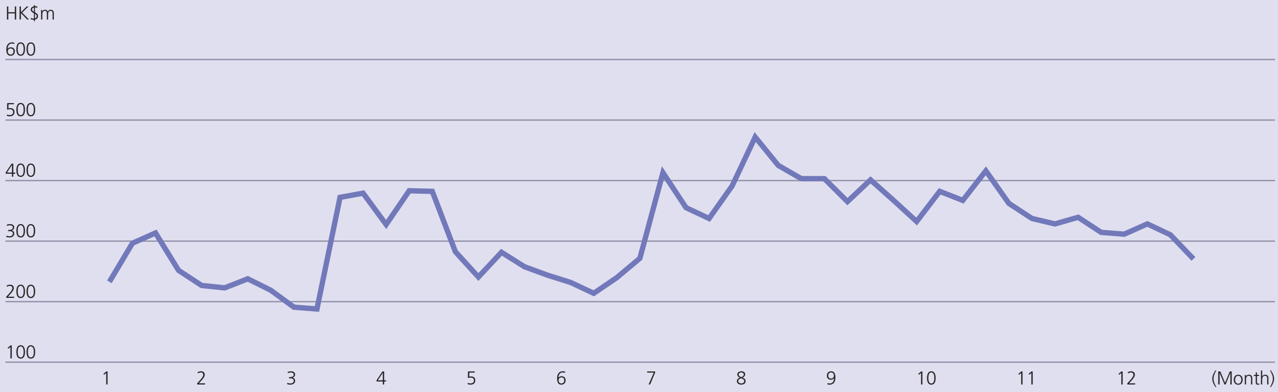
VAR (HK$m)	At 31 December 2003	Minimum during the year	Maximum during the year	Average for the year
VAR for all interest rate risk and foreign exchange risk	271	186	473	321
VAR for foreign exchange risk (trading)	57	2	156	32
VAR for interest rate risk				
– trading	1	1	11	4
– accrual	264	186	472	315

The average daily revenue earned from market risk-related treasury activities in 2004, including accrual book net interest income and funding related to dealing positions, was HK$10 million (HK$8 million for 2003). The standard deviation of these daily revenues was HK$5 million (HK$7 million for 2003). An analysis of the frequency distribution of daily revenues shows that out of 249 trading days in 2004, losses were recorded on only two days and the maximum daily loss was HK$6 million. The most frequent result was a daily revenue of between HK$6 million and HK$10 million, with 143 occurrences. The highest daily revenue was HK$38 million.

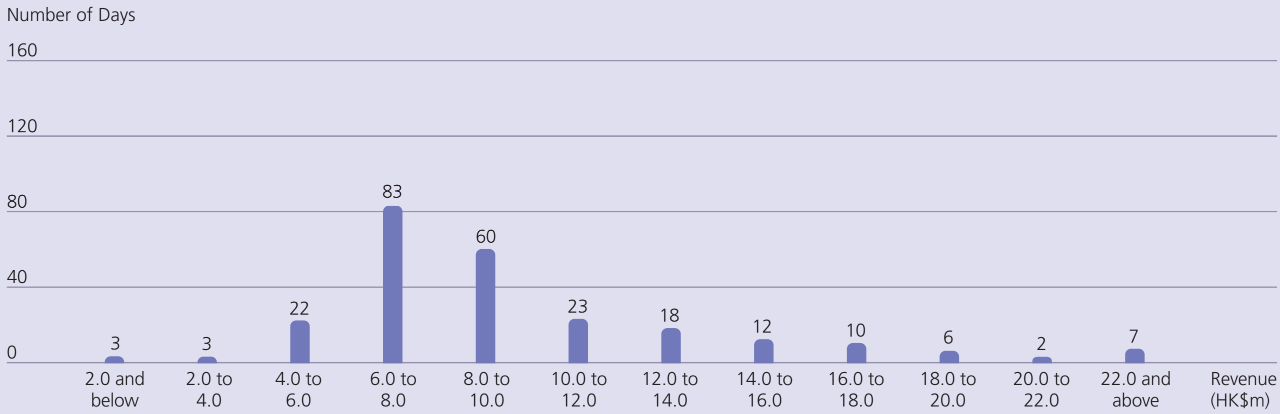
Value At Risk for 2004



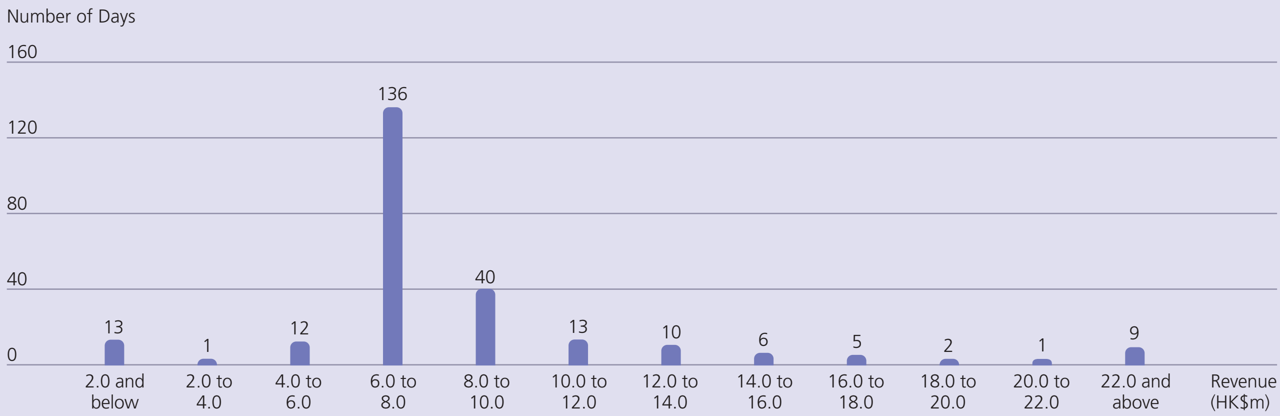
Value At Risk for 2003



Daily Distribution of Market Risk Revenues for 2004



Daily Distribution of Market Risk Revenues for 2003



Foreign exchange exposure

Hang Seng's foreign exchange exposures mainly comprise foreign exchange dealing by Treasury and currency exposures originated by its banking business. The latter are transferred to Treasury where they are centrally managed within foreign exchange position limits approved by the Board of Directors. The average one-day foreign exchange profit for 2004 was HK$4 million (HK$2 million for 2003). Structural foreign exchange positions arising from capital investment in subsidiaries and branches outside Hong Kong, mainly in US dollar and renminbi, are managed by the Asset and Liability Management Committee (ALCO).

At 31 December 2004, the US dollar (US$) and renminbi (RMB) were the currencies in which Hang Seng had a non-structural foreign currency position which exceeded 10 per cent of the total net position in all foreign currencies.

Total foreign currency positions (HK$m)

2004

	USD	RMB	Other foreign currencies	Total foreign currencies
Spot assets	173,071	2,664	112,074	287,809
Spot liabilities	(171,698)	(2,400)	(94,709)	(268,807)
Forward purchases	68,726	207	28,826	97,759
Forward sales	(69,795)	(192)	(46,148)	(116,135)
Net options position	(37)	–	37	–
Net long non-structural position	267	279	80	626
Net structural position	850	1,998	108	2,956

Interest rate exposure

Interest rate risks comprise those originating from treasury activities, both trading positions and accrual books and structural interest rate exposures. Structural interest rate risk arises from the differing repricing characteristics of commercial banking assets and liabilities, including non-interest bearing liabilities, such as shareholders' funds and some current accounts. Structural interest rate risks were transferred to Treasury based on contractual or behavioural maturity directly or through the ALCO book.

Treasury manages interest rate risks within the limits approved by the Board of Directors and under the monitor of ALCO. The average daily revenue earned from treasury-related interest rate activities for 2004 was HK$6 million (HK$6 million for 2003).

Interest rate sensitivity analysis is useful in managing the interest rate risk of the accrual portfolio. The below table discloses the mismatching of the dates on which interest receivable on assets and payable on liabilities are next reset to market rates on a contractual basis, or, if earlier, the dates on which the instruments mature. Actual reset dates may differ from contractual dates owing to prepayments and the exercise of options. In addition, contractual terms may not be representative of the behaviour of assets and liabilities. For these reasons, Hang Seng takes into account behavioural characteristics in the management of its interest rate risk, rather than on the contractual basis set out in the table on page 44.

A positive interest rate sensitivity gap exists where more assets than liabilities re-price in a given period. Although a positive gap position tends to benefit net interest income in a rising interest rate environment, the actual effect will depend on a number of factors, including the extent to which repayments are made earlier or later than the contracted date and variations in interest rates within re-pricing periods and among currencies. Similarly, a negative interest rate sensitivity gap exists where more liabilities than assets re-price during a given period. In this case, a negative gap position tends to benefit net interest income in a declining interest rate environment, but again the actual effect will depend on the same factors as for positive interest rate gaps.

Interest rate sensitivity analysis (HK$m)

2004	Up to 3 months	More than 3 months and up to 6 months	More than 6 months and up to 12 months	More than 12 months	Non-interest earning/ bearing	Trading Book	Total
Assets							
Cash and short-term funds	56,807	–	3,505	–	5,539	2,347	68,198
Placings with banks maturing after one month	11,211	3,101	1,919	–	–	–	16,231
Certificates of deposit	20,539	2,366	4,318	6,348	–	19	33,590
Investment securities	63,977	7,027	11,253	53,821	1,947	1,866	139,891
Advances to customers	222,916	14,781	6,182	5,349	2,546	99	251,873
Other assets*	1,857	896	97	313	33,984	1,695	38,842
Total assets	377,307	28,171	27,274	65,831	44,016	6,026	548,625
Liabilities							
Current, savings and other deposit accounts	417,652	5,617	3,242	7,476	29,429	–	463,416
Deposits from banks	8,018	–	–	–	514	99	8,631
Other liabilities*	3,446	18	–	–	21,954	7,123	32,541
Minority interests	–	–	–	–	852	–	852
Shareholders' funds	–	–	–	–	43,185	–	43,185
Internal funding of the trading book	1,196	–	–	–	–	(1,196)	–
Total liabilities	430,312	5,635	3,242	7,476	95,934	6,026	548,625
Off-balance sheet items	(6,716)	643	2,077	3,996	–	–	–
Net gap position	(59,721)	23,179	26,109	62,351	(51,918)	–	–
Cumulative gap position	(59,721)	(36,542)	(10,433)	51,918	–	–	–

* Amounts due from/to immediate holding company and fellow subsidiary companies are included under other assets and other liabilities.

Equities exposure

Hang Seng's equities exposure in 2004 is mainly in long-term equity investments which are set out in note 20 "Long-term investments" of the financial statements. Equities held for trading purposes are included under "Securities held for dealing purposes" set out in note 15 of the financial statements and are mainly local and Asia equities. These are subject to trading limit and risk management control procedures and other market risk regime.

Derivatives

Positions of derivative contracts outstanding (HK$m)

2004	Contract amount		Mark-to-market values	
	Dealing	Non-dealing	Positive	Negative
Foreign exchange contracts				
Spot and forward	138,269	–	704	670
Currency swaps	779	310	21	15
Currency options	22,069	–	109	106
Interest rate contracts				
Interest rate swaps	49,688	70,915	928	1,347
Interest rate futures	1,741	–	–	–
Interest rate options	3,326	–	11	11
Equity contracts				
Equity futures	11	–	–	–
Equity options	1,362	–	5	5
Analysis of mark-to-market values				
Trading contracts			1,347	1,272
Non-trading contracts			431	882

Derivatives are financial contracts whose value and characteristics are derived from underlying assets, exchange and interest rates, and indices. They mainly include futures, forwards, swaps and options in foreign exchange, interest rate, equity and equity indices and commodities. Derivative positions arise from transactions with customers as well as Hang Seng's own dealing and asset and liability management activities. These positions are managed carefully to ensure that they are within acceptable risk levels.

Derivative instruments are subject to both market risk and credit risk. Market risk from derivative positions is controlled individually and in combination with on-balance sheet market risk positions within Hang Seng's market risk limits regime as described on page 40. The credit risk relating to a derivative contract is principally the replacement cost of the contract when it has a positive mark-to-market value and the estimated potential future change in value over the residual maturity of the contract. The nominal value of the contracts does not represent the amount of Hang Seng's exposure to credit risk. All activities relating to derivatives are subject to the same credit approval and monitoring procedures used for other credit transactions.

The table on page 44 provides an analysis of derivatives by product at 31 December 2004, showing those contracts undertaken for dealing and non-dealing purposes. Hang Seng's derivative positions are mainly in foreign exchange and interest rate contracts. Option contracts are mainly undertaken for option-linked investment/deposit products provided to customers and the related hedges. Mark-to-market values of derivatives designated for dealing purpose are included in "Other assets" for positive amounts and "Other liabilities" for negative amounts.

Operational risk

Operational risk is the risk of economic loss arising through fraud, unauthorised activities, error, omission, inadequate or failed internal process, people and systems or from external events. The management of operational risk comprises the identification, assessment, monitoring, control and mitigation of the risks. Hang Seng appointed its Chief Operating Officer in 2004 to ensure senior management is actively involved in the management of operational risk and is actively overseeing the whole operational risk management framework of the Bank. It's operational risk management framework includes the assignment of responsibility at senior management level; identification of operational risks inherent in processes, activities and products; adequate information systems to record the identification and assessment of operational risks and generate regular management reporting; and rigorous collection and reporting of operational risk losses incurred. This is supported by periodic independent reviews by internal audit of the operational risk management processes, and by monitoring external operational risk events which allows Hang Seng to take account of the lessons learnt.

The risk of losses caused by human error and fraud is mitigated under a well-established internal control environment in which processes are documented, authorisation is independent and where transactions are reconciled and monitored. Details of the internal control system are described in the "Corporate Governance and Other Information" on page 9. Adequate insurance cover is taken to minimise losses in business operation and on the holding of fixed assets. To reduce the impact of and interruptions to business activities caused by system failure or natural disaster, back-up systems and contingency business resumption plans are in place for all business and critical back-office functions. Back-up computer systems and business resumption back-up sites are maintained. Detailed contingency recovery procedures are clearly documented, with periodic drills conducted to ensure the procedures are current and correct.