FINANCIAL REVIEW

FINANCIAL PERFORMANCE
Income Statement

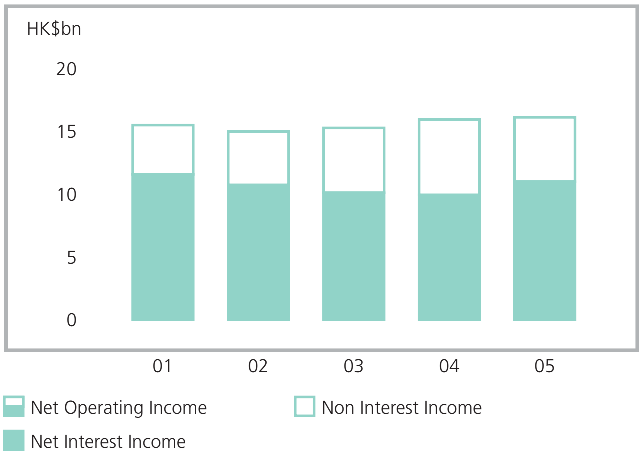
Summary of financial performance (HK$m)	2005	2004 restated
Total operating income	23,246	19,825
Total operating expenses	4,546	4,232
Operating profit excluding loan impairment charges and other credit risk provisions	11,686	11,821
Profit before tax	13,358	13,283
Profit attributable to shareholders	11,342	11,364
Earnings per share (HK$)	5.93	5.94

Hang Seng Bank Limited ("the Bank") and its subsidiaries and associates ("the Group") reported an audited profit attributable to shareholders of HK$11,342 million for 2005, representing a marginal decline of 0.2 per cent compared with 2004. Earnings per share was HK$5.93 (HK$5.94 in 2004).

Total operating income rose by HK$3,421 million, or 17.3 per cent, to HK$23,246 million.

The rise in total operating income was underpinned by the strong growth in net interest income and net premiums earned on life insurance business. After deducting net insurance claims incurred and movement in policyholder liabilities, net operating income before loan impairment charges and other credit risk provisions rose by HK$179 million, or 1.1 per cent, to HK$16,232 million.

Net Operating Income
(Before loan impairment (charges)/releases and other credit risk provisions)



Net interest income increased by HK$1,063 million, or 10.6 per cent.

Figures in HK$m	2005	2004 restated
Net interest income*	11,068	10,005
Average interest-earning assets	505,221	480,317
Net interest spread (% p.a.)	1.94	2.00
Net interest margin (% p.a.)	2.19	2.08

* Included within net interest income is HK$20 million in respect of interest income accrued on impaired loans and advances.

The rise in net interest income was attributable to an increase of HK$24.9 billion, or 5.2 per cent, in average interest-earning assets. Net interest margin improved by 11 basis points to 2.19 per cent. Net interest spread fell 6 basis points to 1.94 per cent, while the contribution from net free funds rose by 17 basis points to 0.25 per cent, benefiting from the steady rise in market interest rates.

The gradual rise in market interest rates in 2005 led to a widening of deposit spreads and boosted the contribution made by net free funds. The net interest margin also benefited from the growth in customer advances, particularly higher yielding cards and personal and SME loans, and the increase in interest earned on the life insurance debt securities portfolio. The exclusion of HK$272 million in net interest expense of the trading and fair value portfolio following the change in accounting presentation in 2005 also contributed to the increase in net interest income.

Treasury securities investment and money market portfolios were negatively affected by the rise in funding costs and the flattening of yield curves. Average mortgage portfolio yields were lower than in 2004, although new mortgage pricing moved up gradually in the second half of 2005.

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

	Net interest income HK$m	Net interest margin basis points
Widening of deposit spreads	354	7
Increase in interest income from insurance fund assets	148	3
Narrowing of spreads on treasury securities investment and money market portfolios	(758)	(15)
Fall in mortgage portfolio yields	(199)	(4)
Contribution from net free funds	859	17
Loan growth and spread improvement	137	3
Growth in average interest-earning assets	522	–
Total	1,063	11

The average yield on the residential mortgage portfolio (excluding GHOS mortgages and staff loans) was 225 basis points below the Best Lending Rate ("BLR") for 2005, compared with 202 basis points below BLR in 2004. The average yield was on a downward trend during the first half of 2005 but stabilised in the second half, with BLR and mortgage pricing gradually moving up. Mortgage incentive payments totaled HK$91 million, compared with HK$157 million in 2004.

With effect from 1 January 2005, and in accordance with HKAS 30, interest income and expense of financial instruments for trading and designated at fair value are reported as net trading income and net income from financial instruments designated at fair value respectively. The following table shows the total net interest income from all sources for both years on a comparable basis.

Figures in HK$m	2005	2004 restated
Net interest income as per income statement	11,068	10,005
Interest income less expense from:		
– trading financial instruments	(306)	–
– fair value financial instruments	34	–
Total net interest income	10,796	10,005

FINANCIAL REVIEW (continued)

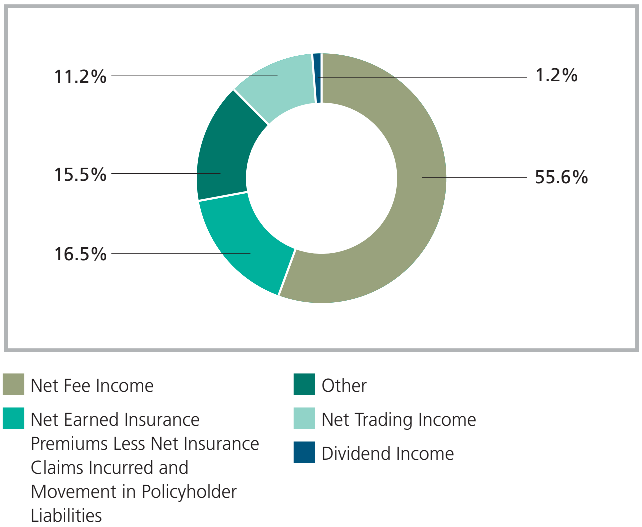
The average balance sheet analysis shows the average balances, interest income/expense and average interest rates of individual assets and liabilities in 2005 as compared with 2004.

	Year ended 31 December 2005			Year ended 31 December 2004 (restated)		
	Average balance HK$m	Interest income HK$m	Yield %	Average balance HK$m	Interest income HK$m	Yield %
Assets						
Balances and placings with and advances to banks	65,905	2,301	3.49	69,548	1,771	2.55
Advances to customers	255,825	10,305	4.03	243,273	6,871	2.82
Financial investments	183,491	6,423	3.50	167,496	4,140	2.47
Total interest-earning assets	505,221	19,029	3.77	480,317	12,782	2.66
Loans impairment allowances	(983)	–	–	–	–	–
Provisions for bad and doubtful debts	–	–	–	(1,696)	–	–
Non interest-earning assets and trading assets	57,535	–	–	29,637	–	–
Total assets and interest income	561,773	19,029	3.39	508,258	12,782	2.51

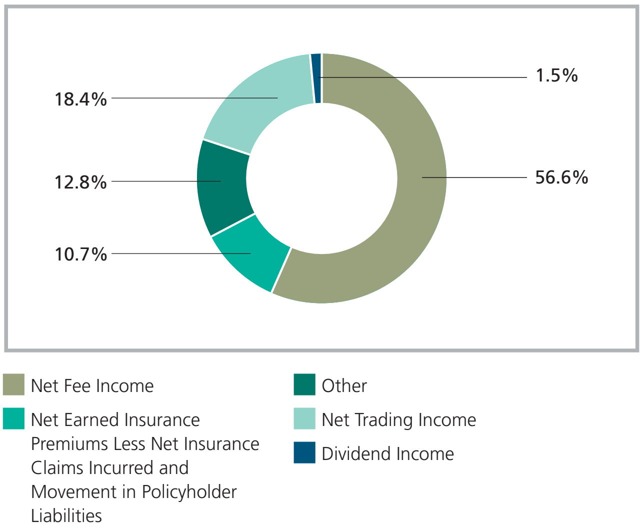
	Average balance HK$m	Interest expense HK$m	Cost %	Average balance HK$m	Interest expense HK$m	Cost %
Liabilities						
Current, savings and other deposit accounts	400,237	6,796	1.70	396,785	2,261	0.57
Deposits from banks	23,209	717	3.09	11,264	203	1.80
Certificates of deposit and debt securities in issue	11,847	412	3.48	9,857	231	2.34
Subordinated liabilities	913	36	3.94	–	–	–
Other interest-bearing liabilities	15	–	–	3,119	82	2.63
Total interest-bearing liabilities	436,221	7,961	1.83	421,025	2,777	0.66
Non interest-bearing current accounts	25,857	–	–	27,690	–	–
Shareholders' funds, other non interest-bearing liabilities and trading liabilities	99,695	–	–	59,543	–	–
Total liabilities and interest expenses	561,773	7,961	1.42	508,258	2,777	0.55

Non interest income decreased by HK$884 million, or 14.6%.

Non Interest Income for 2005



Non Interest Income for 2004



Net fee income fell by HK$551 million, or 16.1 per cent.

It was due mainly to lower sales of longer-term capital-guaranteed funds. Under a rising interest rate environment, investors shifted their focus to other investment products such as market-linked instruments, which generated trading income instead of fees and commissions. Income from securities brokerage and related services fell, affected by the fall in retail investor activity. Credit facilities fee fell by HK$151 million, primarily due to the amortisation of fees as part of effective interest income under the new accounting standards. Private banking investment and advisory income, card services income and insurance agency commissions, however, recorded encouraging growth.

Net trading income was down HK$534 million, or 48.0 per cent.

This was mainly due to certain changes in accounting presentation: the inclusion of net interest expense of HK$306 million for trading assets and liabilities, revaluation losses of HK$145 million on forward foreign exchange contracts linked to money market transactions, and the reduction in the income of HK$89 million from the trading portfolio of life insurance fund assets following their re-designation as financial assets designated at fair value. Income earned on structured transactions provided to personal and corporate customers rose significantly, as demand rose for market-linked instruments in the rising interest rate environment. This was, however, offset by the fall in foreign exchange income due to reduced customer activity, losses recorded on the trading of securities and interest rate instruments, and revaluation losses on financial instruments which failed to satisfy the hedging criteria of HKAS 39.

Net earned insurance premiums rose by HK$3,445 million, or 77.9 per cent.

It reflected the strong growth in premiums earned from both new and existing life insurance policies. Annualised premiums rose by 66.4 per cent, with an increase both in the number of policies concluded and in the premium per policy, reflecting the successful launch of new products providing comprehensive life cover and potential enhancement in investment return.

FINANCIAL REVIEW (continued)

Other operating income rose by HK$25 million, or 3.2 per cent.

It was attributable mainly to the growth in embedded value of long-term life insurance contracts.

Analysis of income from wealth management businesses

Figures in HK$m	**2005**	2004 restated
Investment income:		
– retail investment products and funds under management*	**1,199**	1,413
– private banking	**188**	123
– stockbroking and related services	**493**	560
– margin trading	**63**	66
Total investment income	**1,943**	2,162
Insurance income:		
– life insurance		
– underwriting including embedded value	**869**	623
– life investment income**	**406**	418
– general insurance and others	**270**	269
Total insurance income	**1,545**	1,310
Total	**3,488**	3,472

* Income from retail investment products and funds under management includes income reported under net fee income on the sale of unit trust funds and third party investment products. It also includes profits on the issue of structured investment products reported under net trading income.

** Investment income from insurance funds includes income reported as net interest income, net trading income and net income from financial instruments designated at fair value.

Wealth management income rose by HK$16 million, with the 17.9 per cent growth in insurance income making up for the 10.1 per cent reduction in income from investment services. The life insurance business continued to gain momentum, achieving a 66.4 per cent growth in annualised premiums and gaining market share, with an increase in both the number of policies concluded and in the premium per policy. New products, such as "Three Year Express Wealth", which provides comprehensive life cover and potential enhancement in investment return, have been very well received.

The investment services business became more diversified in 2005. Under a rising interest rate environment, focus was shifted from the sale of longer-term, capital-guaranteed funds which generate higher upfront fee income, to the issue of shorter-term, market-linked deposits and instruments which turn over more quickly but with lower profit margins. Private banking business continued to expand its customer base and funds under management, and reported growth of 52.8 per cent in investment services and advisory fees. Stockbroking and related services, however, fell by 12.0 per cent, affected by the fall in retail investor activity.

Total funds under management, including discretionary and advisory, grew by 18.1 per cent to HK$106.2 billion.

Funds under management

Figures in HK$m	**2005**	2004
At 1 January	**89,932**	57,861
Additions	**59,532**	70,619
Withdrawals	**(45,507)**	(43,166)
Change in fair value	**2,522**	4,213
Exchange adjustments	**(261)**	405
At 31 December	**106,218**	89,932

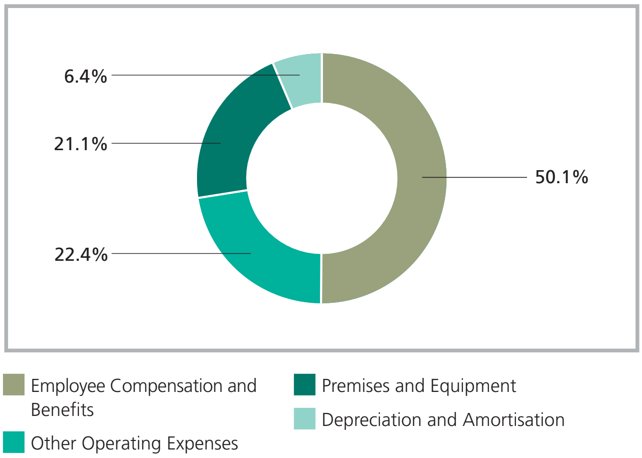
Funds under management of HK$106,218 million was HK$16,286 million, or 18.1 per cent, higher than at 31 December 2004, due to expansion of our asset management and private banking businesses.

Net insurance claims incurred and movement in policyholder liabilities rose by HK$3,242 million, or 85.9 per cent.

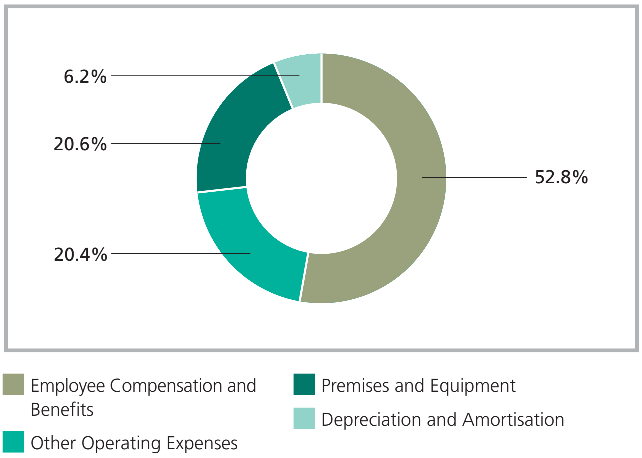
It was in line with the growth in the portfolios of life insurance policies in force. Claims for general insurance business remained stable.

Operating expenses rose by HK$314 million, or 7.4 per cent.

Operating Expenses for 2005



Operating Expenses for 2004



Staff costs increased by 2.1 per cent, attributable to the salary increment at the beginning of the year and the increase in staff number. The 14.0 per cent increase in general and administrative expenses was mainly attributable to information technology expenditure on the enhancement of the Group's e-Banking platform, credit management systems and new product launches. The Group stepped up its marketing expenditure to support the launch of new investment and insurance products and credit card promotion campaigns. Besides, processing fees also increased with the further migration of back-office functions to HSBC Group service centres. Depreciation of business premises and equipment rose by 9.4 per cent was due to the increase in fair value of Group premises.

Staff numbers by region*

	2005	2004 restated
Hong Kong	**7,425**	7,228
Mainland and others	**420**	314
Total	**7,845**	7,542

* Full-time equivalent

The number of full-time equivalent staff increased by 303. The increased staff number in Hong Kong was mainly to further strengthen the Personal Financial Services and Commercial Banking relationship management teams. The expansion of the Group's Mainland network in 2005 (with the opening of a branch in Beijing and two sub-branches in Shanghai, plus the expansion of the Fuzhou branch) brought the Mainland workforce to 377 full-time equivalent staff at 31 December 2005, an increase of 32.7 per cent over the previous year-end.

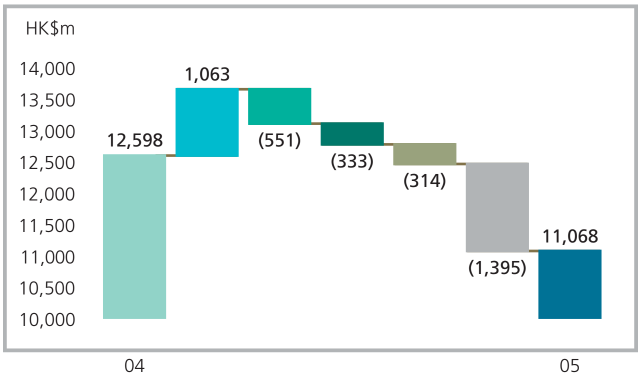
The cost efficiency ratio for 2005 was 28.0 per cent, compared with 26.4 per cent for 2004.

Operating profit

Operating profit excluding loan impairment charges and other credit risk provisions was HK$11,686 million, declined by HK$135 million, or 1.1 per cent, when compared with 2004. Operating profit fell by HK$1,530 million, or 12.1 per cent to HK$11,068 million.

FINANCIAL REVIEW (continued)

Operating Profit Analysis



2004 Operating Profit	12,598
Changes due to:	
Net Interest Income	1,063
Net Fee Income	(551)
Other Operating Income	(333)
Operating Expenses	(314)
Loan Impairment (Charges)/Releases	(1,395)
2005 Operating Profit	11,068

Loan impairment charges and other credit risk provisions amounted to HK$618 million, compared with a total net release of HK$777 million for 2004.

Figures in HK$m	**2005**	2004 restated
Loan impairment (charges)/releases		
– individually assessed	**(309)**	–
– collectively assessed		
– portfolio basis	**(122)**	–
– individually unimpaired loans	**(187)**	–
	(618)	–
Net (charges)/releases for bad and doubtful debts		
– specific provisions		
– individually assessed	**–**	141
– portfolio assessed	**–**	(176)
– general provisions	**–**	812
	–	777

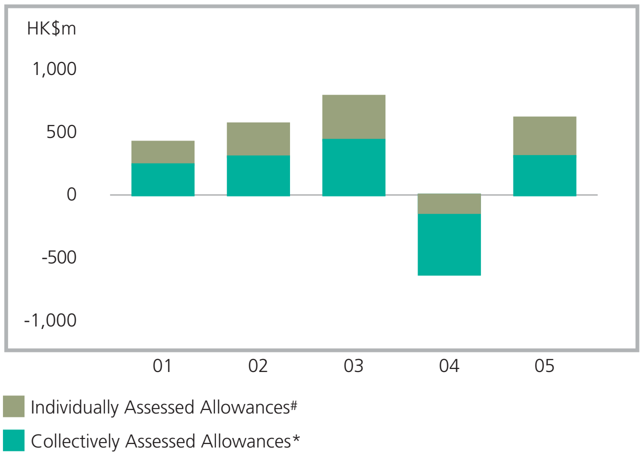
Impairment charges on individually assessed loans amounted to HK$309 million, with the increase in charges on commercial banking accounts partially offset by net releases from mortgages and personal loans, which benefited from rising property prices, falling unemployment, and a reduction in bankruptcy cases. This compared with a net release of HK$141 million, mainly from corporate and commercial banking customer accounts, in 2004. Charges on collectively assessed portfolios of small homogeneous loans amounted to HK$122 million, reflecting the improvement in credit card charge-off rates under the favourable economic environment. This compared favourably with the charge of HK$176 million on loans collectively assessed on a portfolio basis in 2004. Collective assessment of the loans not individually identified as impaired recorded a charge of HK$187 million, as loss rates were updated in the light of historic experience. This compared with a release of HK$812 million in 2004.

Total loan impairment allowances/provisions for bad and doubtful debts as a percentage of gross advances to customers are as follows:

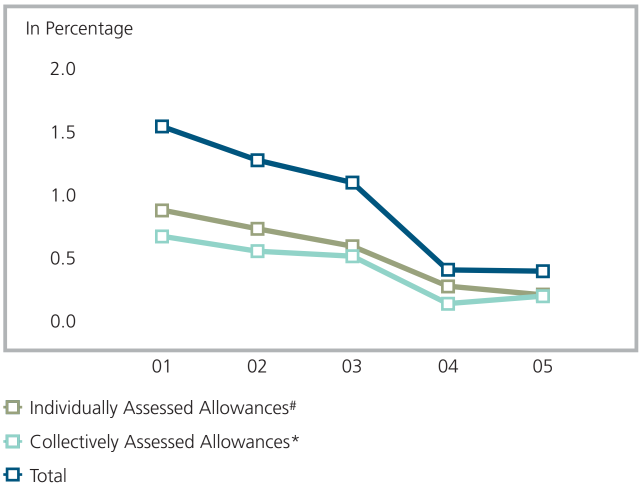
Figures in HK$m	**2005**	2004 restated
	%	%
Loans impairment allowances		
– individually assessed	**0.20**	–
– collectively assessed		
– portfolio basis	**0.01**	–
– loans not individually identified as impaired	**0.18**	–
Total loans impairment allowances	**0.39**	–
Provisions for bad and doubtful debts		
– specific provisions		
– individually assessed	**–**	0.27
– portfolio assessed	**–**	0.01
– general provisions	**–**	0.12
Total provisions	**–**	0.40

Total loan impairment allowances as a percentage of gross advances to customers stood at 0.39 per cent at 31 December 2005, compared with 0.40 per cent at the previous year-end. Individually assessed allowances as a percentage of gross advances fell to 0.20 per cent, reflecting the writing off of irrecoverable balances against impairment allowances, and the release of impairment allowances on mortgages and personal loans under the favourable economic environment. Collectively assessed allowances were 0.19 per cent of gross advances to customers.

Net Charges/(Releases) for Loan Impairment Allowances



Loan Impairment Allowances as a Percentage of Gross Advances to Customers



For 2001 to 2004, individually assessed allowances only include specific provisions assessed on individual basis.

* For 2001 to 2004, collectively assessed allowances include the specific provisions assessed on a portfolio basis plus general provisions.

Profit on disposal of fixed assets and financial investments was HK$477 million, compared with HK$442 million in 2004.

The profit on disposal of financial investments comprises gains on sales of equity securities less losses on disposals of available-for-sale debt securities.

Net surplus on property revaluation went up by HK$1,167 million.

Figures in HK$m	**2005**	2004 restated
Net surplus on property revaluation		
– bank premises	153	146
– investment properties	1,160	–
	1,313	146

On 30 September 2005, the Group's premises and investment properties were revalued by DTZ Debenham Tie Leung Limited who confirmed that there had been no material change in valuation at 31 December 2005. The valuation was 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 for existing use and the basis of valuation for investment properties was open market value. The revaluation surplus for Group premises amounted to HK$1,199 million of which HK$153 million was a reversal of revaluation deficits previously charged to the income statement. The balance of HK$1,046 million was credited to the property revaluation reserve. Revaluation gains on investment properties of HK$1,160 million were recognised through the income statement on adoption of HKAS 40. The related deferred tax provisions for Group premises and investment properties were HK$210 million and HK$203 million respectively.

FINANCIAL REVIEW (continued)

Share of profits from associates rose by HK$403 million.

This was primarily from our Mainland associate, Industrial Bank Co., Ltd.

Economic profit

Economic profit is calculated from post-tax profit, adjusted for any surplus/deficit arising from property revaluation and depreciation attributable to the revaluation surplus, and takes into account the cost of capital invested by the Bank's shareholders. For the year 2005, economic profit was HK$6,084 million, a decrease of HK$1,291 million, or 17.5 per cent, as compared with 2004. Post-tax profit, adjusted for the property revaluation surplus net of deferred tax (HK$1,083 million) and depreciation attributable to the revaluation surplus (HK$44 million), fell by HK$1,023 million, due to a large release in general provisions in the same period in 2004. The cost of capital rose by HK$277 million, in line with the growth in invested capital. The economic profit figure indicates that the Bank continues to create value for its shareholders.

Economic profit (HK$m)	2005	%	2004 restated	%
Average invested capital	36,000		34,084	
Return on invested capital*	10,303	28.6	11,317	33.2
Cost of capital	(4,219)	(11.7)	(3,942)	(11.6)
Economic profit	6,084	16.9	7,375	21.6

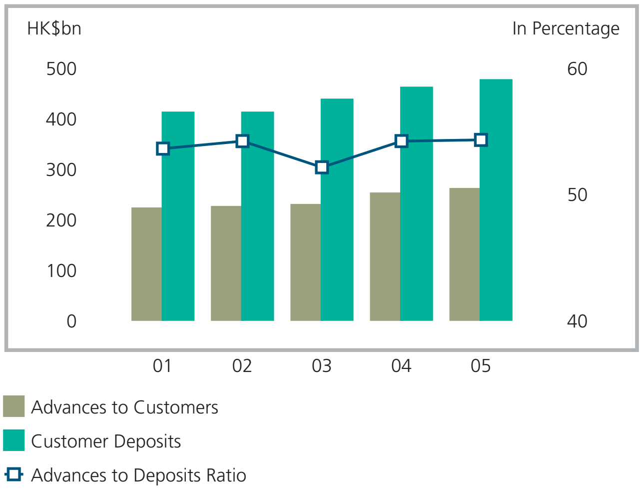
* Return on invested capital is based on post-tax profit excluding any surplus/deficit arising from property revaluation and depreciation attributable to the revaluation surplus.

Balance Sheet

At 31 December 2005, total assets were HK$580.8 billion, an increase of HK$33.9 billion, or 6.2 per cent. Advances to customers grew by 3.6 per cent, mainly reflecting the rise in cards and personal advances, and growing demand from the property and manufacturing sectors. Loan portfolios of the Mainland branches also grew significantly. Customer deposits and certificates of deposit and other debt securities in issue increased by 3.4 per cent. The expansion in balance sheet size was also driven by the growth in life insurance fund assets and related liabilities to policyholders.

At 31 December 2005, the advances-to-deposits ratio was 54.4 per cent, compared with 54.3 per cent a year earlier, reflecting steady growth in both customer advances and deposits.

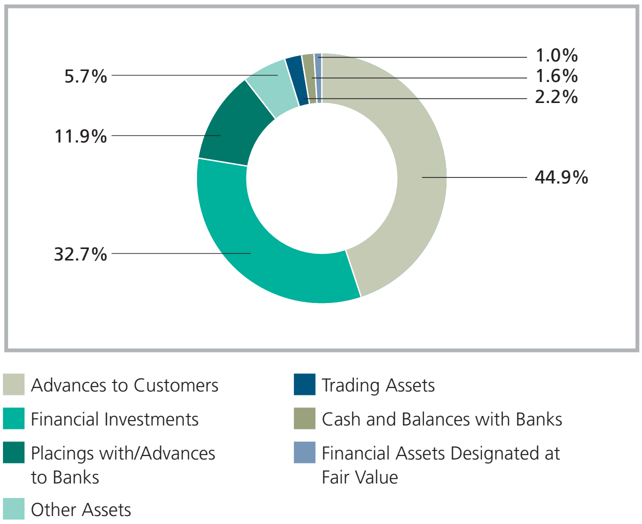
Advances to Customers and Customer Deposits



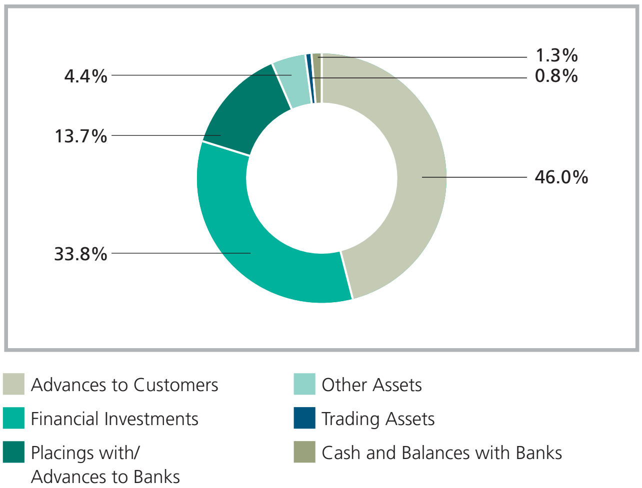
Assets deployment

At 31 December (HK$m)	**2005**	**%**	2004 restated	%
Cash and balances with banks	**9,201**	**1.6**	7,248	1.3
Placings with and advances to banks	**69,286**	**11.9**	75,079	13.7
Trading assets	**12,600**	**2.2**	4,232	0.8
Financial assets designated at fair value	**6,027**	**1.0**	–	–
Advances to customers	**260,680**	**44.9**	251,553	46.0
Financial investments	**189,904**	**32.7**	184,706	33.8
Other assets	**33,122**	**5.7**	24,129	4.4
Total assets	**580,820**	**100.0**	546,947	100.0

Assets Deployment for 2005



Assets Deployment for 2004



Financial instruments

In accordance with HKAS 39, the Group's financial instruments are classified into the categories of: trading assets, financial assets designated at fair value, available-for-sale securities and held-to-maturity debt securities. On 1 January 2005, all its held-to-maturity debt securities, with the exception of the portfolio of debt securities of life insurance funds, were re-designated as trading assets, financial assets designated at fair value or available-for-sale securities. The table on page 58 shows the re-designation of the individual categories of financial instruments at transition and the movements during the year of 2005.

FINANCIAL REVIEW (continued)

Financial instruments	Balances at 31 December 2004	Re-designation and fair value recognition# on 1 January 2005 Held-to-maturity	Available-for-sale	Trading assets	Financial assets designated at fair value	Total
Securities held for dealing purposes	4,232	–	–	4,232	–	4,232
Long term investments						
– Held-to-maturity debt securities	181,100	6.098	160,979	12,505	2,524	182,106#
– Equity investment	1,838	–	1,838	–	–	1,838
Other financial assets attributable to policyholders	1,768	–	–	–	1,768	1,768
	188,938	6,098	162,817	16,737	4,292	189,944
Increase/(decrease) during the year of 2005		4,633	16,356	(4,137)	1,735	18,587
Balances at 31 December 2005		10,731	179,173	12,600	6,027	208,531

Following the adoption of HKAS 39, the available-for-sale securities and financial assets designated at fair value are measured at fair value.

Advances to customers

Advances to customers recorded a growth of HK$9.1 billion, or 3.6 per cent, to HK$260.7 billion at 31 December 2005.

Lending to the industrial, commercial and financial sectors rose by 5.3 per cent during 2005. Property development and investment grew by 8.4 per cent, reflecting the active property market. Wholesale, retail and manufacturing together were up by 35.3 per cent, driven by the continued expansion of the economy and growth in external trade. Lending to the transport and transport equipment sector, including taxi and other motor vehicle loans, recorded growth of 6.7 per cent. Financial concerns lending fell by 75.8 per cent, due mainly to the repayment of a money market loan from a public sector entity.

Lending to individuals fell by 0.4 per cent compared with the end of 2004. Excluding mortgages under the GHOS Scheme, which remained suspended during 2005, lending to individuals grew by 3.2 per cent. Residential mortgages went up by 1.7 per cent in an active and competitive market. Card advances rose by 18.4 per cent, reflecting increases in card spending and in the card base of 19.7 per cent and 10.2 per cent respectively. Personal loans, grouped under the "Other" sector, grew by 51.8 per cent, reflecting the success of the Group in expanding its consumer finance business.

Trade finance advances rose by 2.2 per cent. The growth in trade finance to commercial banking customers, who benefited from the strong regional trade flows, was partly offset by repayments made by certain trading corporations.

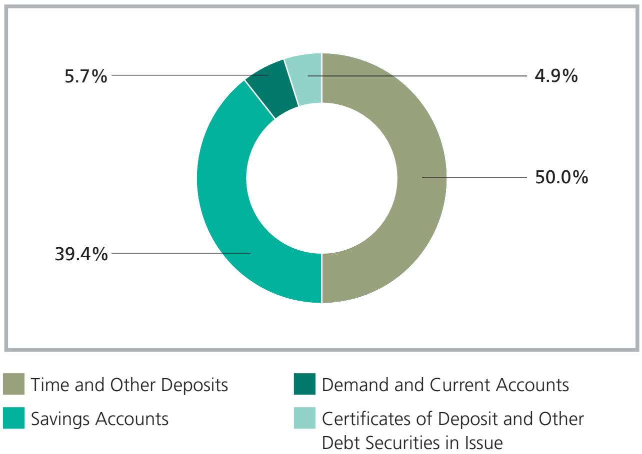
Gross advances for use outside Hong Kong recorded growth of 31.1 per cent. The loan portfolio of the Mainland branches expanded by 41.9 per cent in 2005 to HK$10.5 billion, with encouraging growth recorded in commercial and residential mortgage lending.

Customer deposits

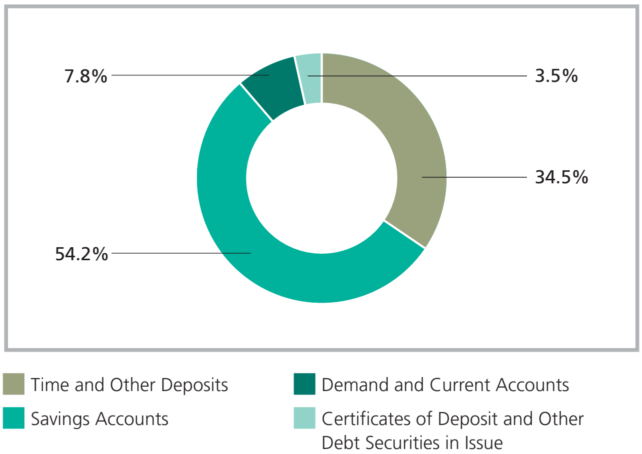
Customer deposits, including certificates and other debt securities in issue, rose 3.4 per cent to HK$479.1 billion.

Current, savings and other deposit accounts (including structured deposits reported as trading liabilities) rose by HK$8.0 billion, or 1.8 per cent, to HK$455.4 billion at 31 December 2005. Certificates of deposit and other debt securities in issue (including those reported as trading liabilities) recorded encouraging growth of HK$7.6 billion, or 47.2 per cent, to HK$23.6 billion at 31 December 2005. In the rising interest rate environment, customer deposits have shifted from current and savings accounts to time deposits. Certificates of deposit and structured deposit instruments with yield enhancement features also gained in popularity.

Customer Deposits for 2005



Customer Deposits for 2004



Subordinated liabilities

During the year, the Bank issued subordinated notes amounting to HK$2,500 million (comprising a floating rate tranche of HK$1,500 million and a fixed rate tranche of HK$1,000 million) to the market and obtained a subordinated loan of US$260 million from its immediate holding company. These subordinated debts, which qualify as tier 2 capital, served to balance the Bank's capital structure as well as to support business growth.

Shareholders' funds

At 31 December (HK$m)	**2005**	2004 restated
Share capital	**9,559**	9,559
Retained profits	**26,052**	23,856
Property revaluation reserve	**3,543**	2,778
Long-term equity investment revaluation reserve	**–**	935
Cash flow hedges reserve	**(483)**	–
Available-for-sale investment reserve	**(17)**	–
Capital redemption reserve	**99**	99
Other reserves	**185**	69
Total reserves	**29,379**	27,737
	38,938	37,296
Proposed dividends	**3,633**	3,633
Shareholders' funds	**42,571**	40,929
Return on average shareholders' funds	**27.5%**	28.5%

Save for the issuance of subordinated notes in June 2005, there was no purchase, sale or redemption of the Group's listed securities by the Bank or any of its subsidiaries during 2005.

Shareholders' funds (excluding proposed dividends) rose by HK$1,642 million, or 4.4 per cent, to HK$38,938 million at 31 December 2005. Retained profits increased by HK$2,196 million, and the property revaluation reserve rose by HK$765 million reflecting the improved property market. These were partially offset by the HK$500 million revaluation loss on available-for-sale investment securities, and on interest rate swaps designated as cash flow hedges.

The return on average shareholders' funds was 27.5 per cent, compared with 28.5 per cent in 2004.

FINANCIAL REVIEW (continued)

The following matrix sets out the financial assets and liabilities by type and by accounting classification on adoption of HKAS 39.

At 31 December 2005 (HK$m)	Trading	Designated at fair value	Available-for-sale	Amortised cost	Total
Assets					
Cash and balances with banks and other financial institutions	–	–	–	9,201	9,201
Placings with and advances to banks and other financial institutions	–	–	–	69,286	69,286
Treasury bills	2,594	–	4,816	–	7,410
Certificates of deposit	538	194	25,909	1,138	27,779
Investment securities	9,468	5,833	148,448	9,593	173,342
Derivative financial instruments	1,245	16	454	–	1,715
Advances to customers	–	–	–	260,680	260,680
Total financial assets					549,413
Other assets					31,407
Total assets					580,820
Liabilities					
Deposits by banks	–	–	–	12,043	12,043
Customer accounts	24,422	–	–	430,995	455,417
Certificates of deposit and other debt securities in issue	13,616	–	–	10,023	23,639
Securities net short position	7,766	–	–	–	7,766
Derivative financial instruments	1,307	28	457	–	1,792
Liabilities to customers under investment contracts	–	–	–	561	561
Subordinated liabilities	–	967	–	3,511	4,478
Total financial liabilities					505,696
Liabilities to customers under insurance contracts					15,335
Other liabilities					16,059
Total liabilities					537,090

CAPITAL MANAGEMENT

Capital Resources Management

At 31 December (HK$m)	**2005**	2004
Capital base		
Tier 1 capital		
– share capital	**9,559**	9,559
– retained profits	**21,439**	20,560
– classified as regulatory reserve	**(510)**	–
– capital redemption reserve	**99**	99
– less: goodwill	**(318)**	(302)
– total	**30,269**	29,916
Tier 2 capital		
– property revaluation reserve	**5,114**	5,322
– available-for-sale investment and equity revaluation reserve	**(5)**	625
– collective impairment allowances	**510**	289
– regulatory reserve	**510**	–
– term subordinated debt	**4,479**	–
– total	**10,608**	6,236
Unconsolidated investments and other deductions	**(3,444)**	(2,829)
Total capital base after deductions	**37,433**	33,323
Risk-weighted assets		
On-balance sheet	**277,617**	259,429
Off-balance sheet	**14,739**	16,577
Total risk-weighted assets	**292,356**	276,006
Total risk-weighted assets adjusted for market risk	**291,570**	277,029
Capital adequacy ratios		
After adjusting for market risk		
– tier 1*	**10.4%**	10.8%
– total*	**12.8%**	12.0%
Before adjusting for market risk		
– tier 1	**10.4%**	10.8%
– total	**12.8%**	12.1%

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

The total capital ratio rose by 0.8 percentage points over 2004 to reach 12.8 per cent at 31 December 2005. The capital base increased by HK$4,110 million to HK$37,433 million. During the year, the Group issued HK$2,500 million in subordinated notes and obtained a subordinated loan of US$260 million, both qualified as tier 2 capital. Risk-weighted assets adjusted for market risk grew by 5.2 per cent, attributable mainly to the increase in advances to customers and financial investments.

RISK MANAGEMENT

The effectiveness of the Group's risk management polices and strategies is a key success factor. Operating in the financial services industry, the most important types of risks the Group is exposed to are credit, liquidity, market, operational and reputational risks. The Group has established policies and procedures to identify and analyse risks and to set appropriate risk limits to control this broad spectrum of risks. The risk management policies and major control limits are approved by the Board of Directors. Risk limits are monitored and controlled continually by dedicated departments by means of reliable and up-to-date management information systems. The management of various types of risks is well coordinated at the level of the Bank's Board and various management committees, such as, the Executive Committee, Asset and Liability Management Committee and Credit Committee.

Discussions and analyses of credit risk, liquidity risk and market risk are set out in note 50 "Financial risk management" to the financial statements to compliance with the requirements of HKAS 32.

Market Risk

The Group's market risk positions are mainly in foreign exchange and interest rate. In addition to the risk management procedures as set out in note 50 to the financial statements, the Group also uses value-at-risk ("VAR") methodology to control its market risk exposures. The Group has obtained approval from the HKMA to use its VAR model for calculation of market risk capital charge.

FINANCIAL REVIEW (continued)

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. In line with the HSBC Group, Hang Seng refined its basis of calculating VAR from one predominantly based on variance/co-variance ("VCV") to one predominantly based on historical simulation ("HS"), effective 3 May 2005. This latter calculation was introduced because it better captures the non-linear characteristics of certain market risk positions. Historical simulation uses scenarios derived from historical market rates, and takes account of the relationships between different markets and rates, for example, interest rates and foreign exchange rates. Movements in market prices are calculated by reference to market data from the last two years. The Group has changed the assumed holding period from a 10-day period to a one-day period as this reflects the way the risk positions are managed. Comparative VAR numbers have been re-stated to reflect this change. 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.

The Group's VAR for all interest rate risk and foreign exchange risk positions and on individual risk portfolios during 2005 and 2004 are shown in the tables below. The VAR figures for 2005 are based on four months' VCV and eight months' HS.

VAR

Figures in HK$m	**At 31 December 2005**	**Minimum during the year**	**Maximum during the year**	**Average for the year**
VAR for all interest rate risk and foreign exchange risk	113	111	264	181
VAR for foreign exchange risk (trading)	3	–	6	2
VAR for interest rate risk				
– trading	3	1	21	4
– non-trading	118	117	260	180

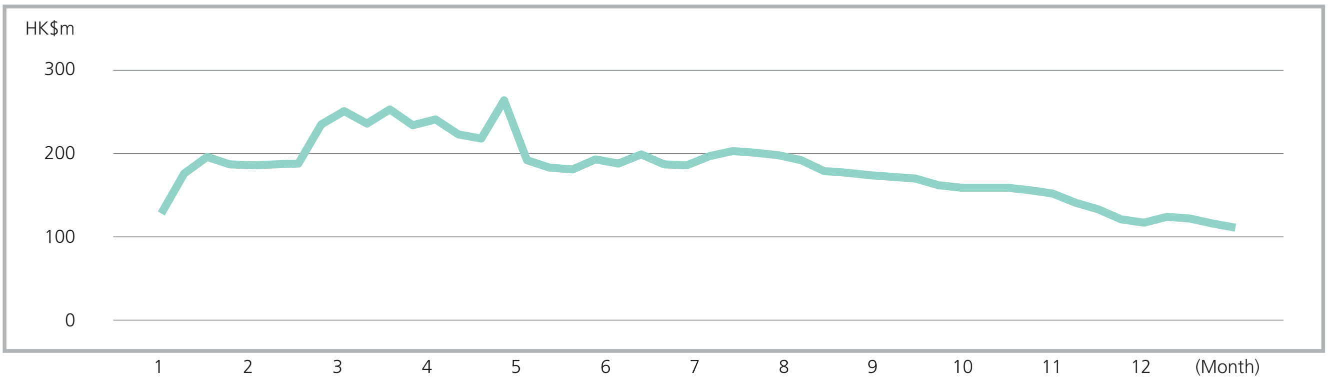
Figures in HK$m	At 31 December 2004 restated	Minimum during the year	Maximum during the year	Average for the year
VAR for all interest rate risk and foreign exchange risk	125	79	191	118
VAR for foreign exchange risk (trading)	1	–	18	11
VAR for interest rate risk				
– trading	1	–	5	1
– non-trading	125	77	191	117

The average daily revenue earned from market risk-related treasury activities in 2005, including non-trading book net interest income and funding related to dealing positions, was HK$5 million (HK$10 million for 2004). The standard deviation of these daily revenues was HK$8 million (HK$5 million for 2004). An analysis of the frequency distribution of daily revenues shows that out of 247 trading days in 2005, losses were recorded on 15 days and the maximum daily loss was HK$84 million. The most frequent result was a daily revenue of between HK$2 million and HK$6 million, with 127 occurrences. The highest daily revenue was HK$23 million.

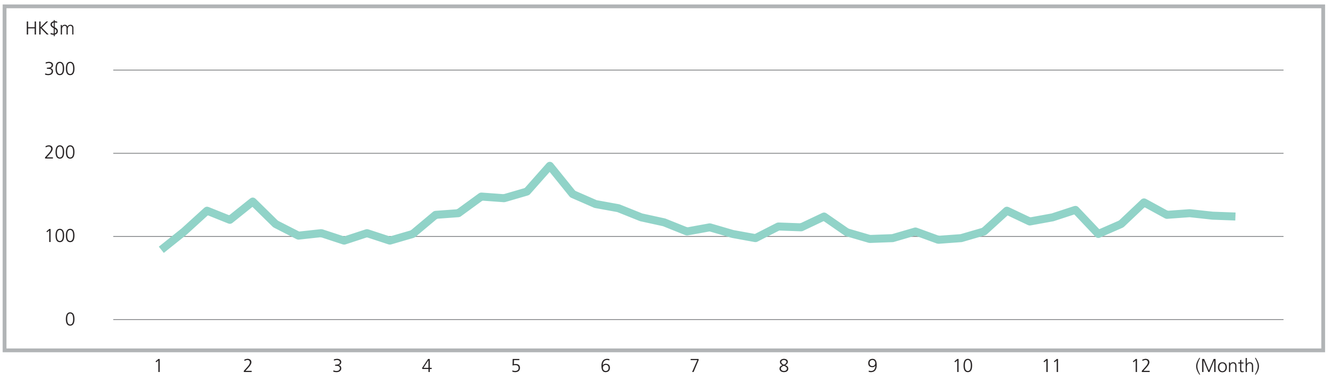
The average daily revenue are analysed by activities as follows:

Figures in HK$m	**2005**	2004
Average daily revenue earned from:		
– interest rate activities	3	6
– foreign exchange activities	2	4

Value at Risk for 2005

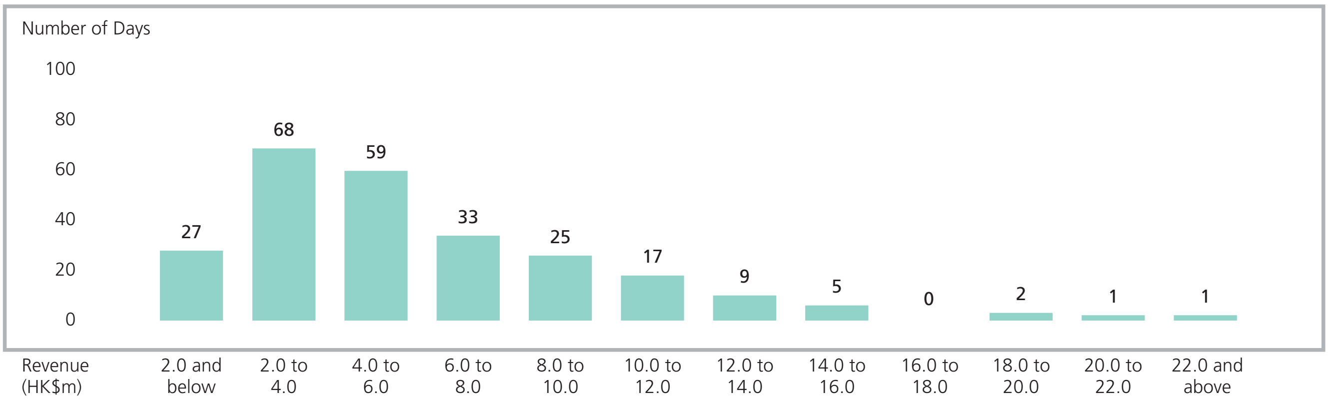


Value at Risk for 2004

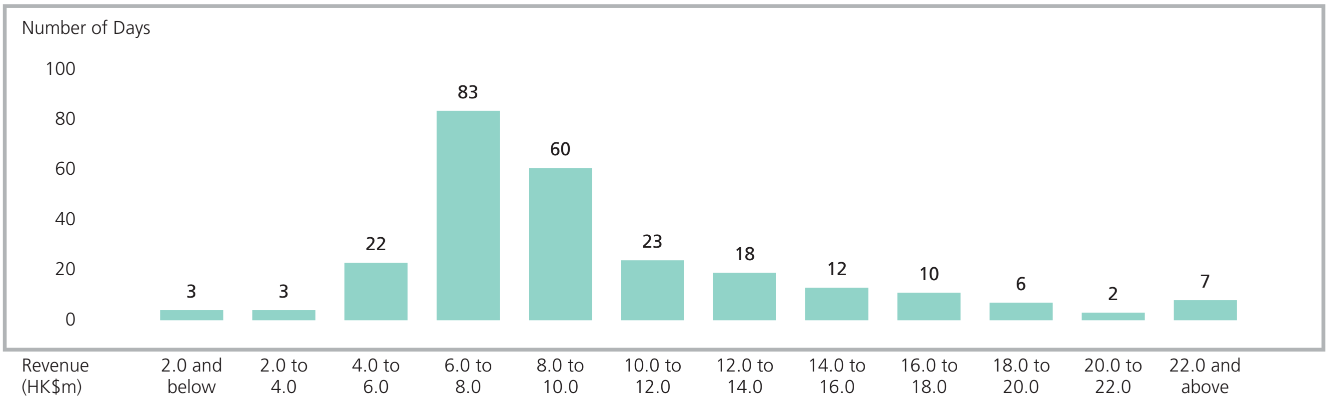


FINANCIAL REVIEW (continued)

Daily Distribution of Market Risk Revenues for 2005



Daily Distribution of Market Risk Revenues for 2004



Operational Risk

Operational risk is the risk of loss arising through fraud, unauthorised activities, error, omission, inefficiency, system failure or from external events. It is inherent in every business area and covers a wide spectrum of issues. The Group manages its operational risk through a controls-based environment in which the processes and controls are documented, authorization is independent and transactions are reconciled and monitored. This is supported by periodic independent review of the internal control systems by Internal Audit. The operational risk management framework comprises assignment of responsibilities at senior management level, assessment of risk factors inherent in each business and operations units, information systems to record operational losses and analysis of loss events. Operational risk is mitigated by adequate insurance coverage on assets and business losses. To reduce the impact 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 operations functions. Operational risk management is coordinated by the Chief Operating Officer and monitored by the Operational Risk Management Committee.

Reputational Risk

Reputational risks can arise from social, ethical or environmental issues, or as a consequence of operational risk events. Standards are set and policies and procedures are established in all areas of reputational risk and are communicated to all level of staff. These include treating customers fairly, conflicts of interest, money laundering deterrence, environmental impact and anti-corruption measures. The reputation downside to the Group will be fully appraised before any strategic decision is taken.

The Group is a socially and environmental responsible organization. Its corporate social responsibility policies and practices are discussed under the "Corporate Social Responsibility" section.