Improved economic conditions and initiatives taken according to our roadmap for growth helped Hang Seng move forward during the first half of 2006 in a keenly competitive banking environment.

Total operating income increased by 18.1 per cent compared with a year earlier to reach HK$12,396 million, reflecting growth in net interest income, trading profit, and income from investment services and insurance.

Operating profit excluding loan impairment charges and other credit risk provisions was up 7.6 per cent at HK$6,387 million. An 88.7 per cent reduction in loan impairment allowances saw operating profit rise by HK$721 million, or 12.8 per cent, to HK$6,353 million.

Pre-tax profit grew by 6.4 per cent to reach HK$7,513 million. Attributable profit after taxation and minority interests was HK$6,190 million, an increase of 2.4 per cent.

Our roadmap

As detailed in our 2005 annual results announcement in March this year, our roadmap sets out key priorities and targets designed to help us grow our business. Although still in the early stages, good progress has already been made.

Relationships with commercial customers, particularly small and medium-sized enterprises (SMEs), were further strengthened through initiatives such as the establishment of a new team to focus on servicing our high value non-borrowing customers and our Business Partner Direct 24-hour hotline as well as the opening of more Business Banking Centres. We also expanded our team of dedicated relationship managers to better serve the needs of middle-market enterprises.

These enhancements helped us win the award for Best Banking Service at the SME's Best Partner Awards 2006 organised by the Hong Kong Chamber of Small and Medium Business.

Commercial Banking increased its contribution to total pre-tax profit, moving closer to our five-year target of 20 per cent.

We grew our mainland China operations by increasing our number of outlets and hiring around 100 new staff. We deepened cooperation with Industrial Bank, focusing on areas such as credit card business, lending and cross-referral of customers.

As reflected in our new corporate tagline 'Managing wealth for you, with you', we stepped up efforts to meet the investment and insurance needs of our customers, driving a 23.9 per cent increase in wealth management income to HK$2,211 million.

With a 40.4 per cent rise in pre-tax profits, Private Banking is on track to meet its target of doubling profit within five years.

Treasury's trading profit increased by 201.6 per cent to HK$368 million following initiatives designed to help us achieve a more customer driven and diversified Treasury income base.

Financial highlights

At a Bank-wide level, net interest income grew by HK$1,111 million, or 21.1 per cent, to HK$6,375 million, excluding HK$847 million in net interest expenses on the trading and fair value portfolios.

The widening of spreads on Best Lending Rate-based loans, improvements in time deposit spreads and the contribution of net free funds outweighed the further compression of treasury balance sheet management portfolio yields and continuing pressure on corporate loan margins and mortgage pricing.

Net interest margin increased by 24 basis points to 2.37 per cent, reflecting a 41 basis point rise in contribution from net free funds and a 17 basis point fall in net interest spread.

Average interest-earning assets grew by 8.7 per cent to HK$541.3 billion. Total assets were up HK$47.5 billion, or 8.2 per cent, at HK$628.3 billion.

The active equities market drove an 88.4 per cent increase in securities-related income to HK$439 million. Along with rises in fee income from private banking and card services, this helped net fee income grow by 13 per cent to HK$1,782 million.

Trading profit was up 69.4 per cent at HK$659 million, attributable primarily to a 120.2 per cent rise in foreign exchange income. However, after deducting trading-related net interest expenses of HK$879 million, a net trading loss of HK$220 million was reported.

Operating expenses rose HK$182 million, or 8.4 per cent, due primarily to salary increases and the hiring of new staff for business expansion. Our number of full-time equivalent employees grew by 200 to 8,045.

However, our cost efficiency ratio remained low at 26.8 per cent, up just 0.1 percentage point on the same period last year.

In June, we enjoyed a good market response to our US dollar subordinated notes issue. The US$450 million offering improved our capital strength and helped expand our investor base inside and outside Hong Kong.

Our total and tier 1 capital ratios at 30 June 2006 were 14.2 per cent and 11 per cent respectively, up from 12.8 per cent and 10.4 per cent at the end of 2005.

We continue to enjoy the highest ratings given to banks in Hong Kong. In June, Moody's upgraded our long-term local currency deposit rating to Aa2 and assigned us a B+ bank financial strength rating. In July, Standard & Poor's raised our local and foreign currency long-term corporate credit ratings to AA.

Shareholders' funds (excluding proposed dividends) were up 6.9 per cent at HK$41,615 million, attributable primarily to a HK$2,575 million increase in retained profits. Return on average shareholders' funds was 29 per cent, one of the highest in the banking sector.

Loans and deposits

Customer deposits, including certificates of deposit and other instruments in issue, recorded growth of 5.4 per cent to reach HK$504.9 billion.

Advances to customers increased by 2.2 per cent to HK$266.5 billion. Continuing efforts to diversify our loan portfolio helped drive good growth in trade finance, commercial banking advances, mortgages and personal loans. This growth outweighed falls in mortgages under the suspended Government Home Ownership Scheme (GHOS) and lending to large corporations.

Lending to individuals (excluding GHOS mortgages) grew by 1.9 per cent. Despite intense competition in the residential mortgage sector, we achieved a 1.8 per cent increase in loan balance and gained market share.

Sustained consumer demand, underpinned by the buoyant labour market, helped personal loans grow by 16.8 per cent during the first half of 2006. Compared with a year earlier, personal loans rose by 41.4 per cent.

Credit card advances fell by 1.9 per cent compared with the end of 2005, due primarily to the repayment of tax bill payment balances. Year on year, card advances were up 15.2 per cent.

Loans to the wholesale and retail trade and the manufacturing industry rose by 7.4 per cent and 7.2 per cent respectively. Compared with 30 June 2005, lending to these sectors increased by 13.9 per cent and 9.3 per cent. Lending for property investment was up 3.6 per cent on the previous year-end and 13.4 per cent year on year. Trade finance recorded strong growth of 19.5 per cent since 31 December 2005 and 12.2 per cent year on year.

Loans for use outside Hong Kong rose by HK$1,951 million, or 12.3 per cent, over the end of 2005, driven primarily by a 21.7 per cent increase in lending by our Mainland branches.

Assisted by the benign credit conditions, loan impairment allowances fell to 0.33 per cent of gross advances to customers as at 30 June 2006, compared with 0.39 per cent at the end of 2005. Gross impaired advances as a percentage of gross total advances were down 0.1 percentage point at 0.4 per cent.

Customer group highlights

Personal Financial Services recorded a 7 per cent growth in operating profit excluding loan impairment charges to HK$3,960 million. Pre-tax profit was HK$3,897 million, a 1.8 per cent decline compared with the same period last year, which benefited from a HK$260 million net release in loan impairment allowances for mortgages and personal loans.

Despite pricing pressures created by keen competition for mortgage and deposits business, we grew net interest income by 5.4 per cent to HK$3,543 million. Average customer deposits rose by 9.1 per cent.

Wealth management income remained a central growth driver. We continued to expand and refine our range of products to take advantage of prevailing market conditions and meet customers' investment and insurance needs at all stages of life.

The buoyant securities market drove a 101.3 per cent rise in trading volume and helped securities-related income grow by 83.5 per cent.

In the rising interest rate environment, investor focus shifted to products offering higher potential returns. Building on our previous success with capital-guaranteed funds, we achieved record high sales of equity and high yield fixed-income funds.

The excellent customer response to our new Monthly Income Retirement Plan underpinned the 28.4 per cent increase in life insurance income to HK$697 million. We continued to gain market share in terms of new annualised premiums.

Private banking recorded significant increases in customer base and assets under management, resulting in strong growth of 42.1 per cent in total operating income.

Continuous customer acquisition efforts and the launch of new cards saw cards in issue grow by 3.6 per cent to 1.32 million. Card spending was up 9.2 per cent year on year.

Commercial Banking's operating profit excluding loan impairment charges increased by an encouraging 21.8 per cent to $933 million, outpacing year-on-year growth of 11.3 per cent in 2005. A HK$26 million net release in loan impairment allowances following a HK$453 million charge at the same time last year led to a 150.8 per cent rise in pre-tax profit to HK$1,096 million. Net interest income rose 25.3 per cent to HK$920 million.

The development of deeper customer relationships helped trade finance and commercial loans grow by 17.8 per cent and 18.1 per cent respectively.

The introduction of corporate wealth management advisors proved effective, contributing to a 21.2 per cent increase in net fees and commissions and a 16.7 per cent growth in net trading income.

Corporate Banking's pre-tax profit benefited from a release in loan impairment allowances, compared with a charge in the same period last year, rising 58.5 per cent to HK$271 million. Operating profit excluding loan impairment charges fell by 8.2 per cent to HK$257 million.

With the competitive lending market and high levels of liquidity driving down margins on corporate loans, Corporate Banking continued with its strategy of diversifying its loan portfolio, cross-selling Treasury products and growing its Mainland client base.

Treasury's trading profit increased by an encouraging HK$246 million following efforts to enhance proprietary trading capability, expand corporate treasury services and introduce more structured products for Personal Financial Services and Commercial Banking customers.

However, with interest rate rises continuing to put pressure on Treasury's balance sheet management portfolios, pre-tax profit fell by 35.5 per cent to HK$506 million.

Business highlights

We further extended our service capabilities and product offerings on the Mainland. In May we opened a fourth Shanghai sub-branch, bringing our network to 13 outlets.

Early this year, our first offsite ATMs on the Mainland were set up in Beijing and Shanghai. Our Fuzhou branch expanded the scope of its RMB and foreign currency services. We received approval for a similar expansion of services at our Nanjing branch, which will be implemented in the third quarter of this year. Trade-related insurance agency services are now available in Guangzhou, Shanghai and Shenzhen. We are among the first group of foreign banks on the Mainland to have received approval to offer RMB foreign exchange swap services.

New products such as market-linked structured deposits helped total Mainland deposits grow by 11.2 per cent during the first half of 2006 and 43.8 per cent year on year. Lending reached HK$12.8 billion, up HK$2.3 billion compared with the end of 2005 and HK$3.8 billion year on year.

Net profit from our strategic investment in Industrial Bank grew by 10 per cent to reach HK$209 million.

Ongoing enhancements to our online services are enabling us to offer more convenient banking to customers. We now have over 577,000 Personal e-Banking users, an increase of 11.1 per cent from the end of 2005. Nearly 33,000 companies currently use our Business e-Banking service.

In the first half of 2006, Internet transactions accounted for 38.2 per cent of all personal banking transactions. This included 66.2 per cent of securities trading, 87.2 per cent of investment fund switching and 80.3 per cent of foreign exchange margin trading, up from 62.9 per cent, 70.1 per cent and 77.7 per cent respectively in the same period last year.

Improvements to our website are helping encourage customers to purchase products and services via online channels. In the first half of this year, 55.2 per cent of our travel insurance sales were completed over the Internet.

Year on year, total online sales and transactional income was up 111.9 per cent.

In May, we sold our 44-year-old building located at 77 Des Voeux Road Central for HK$2.26 billion as part of our property portfolio rationalisation programme. The sale will allow us to make better use of our resources.

To further enhance our operating and cost efficiency we have leased a 262,000 square feet site in Kowloon Bay, with around 1,600 back-office staff expected to take up occupancy at the end of 2007.

Branding

To boost our competitiveness and grow our market share in key customer segments such as young people and SMEs, we are investing in brand strengthening.

This investment will help reinforce our progressive, pragmatic and thoughtful approach that places primary focus on service excellence, enhancing our leadership position as customers' bank of choice.

In late May, we kicked off our integrated branding programme, which covers both advertising and key areas affecting customer experience, such as products, services, points of contact and marketing materials.

We now have two TV commercials that build our brand equity using a testimonial approach. Our branches at China Resources Building in Wan Chai and Cheung Sha Wan Plaza in Lai Chi Kok have adopted new branch design elements. We will refurbish more branches in line with our new brand identity and to provide an enhanced banking experience.

Human resources

In order to attract, develop and retain the best staff, we continue to invest in people development. In addition to the provision of training to enhance the financial knowledge and technical know-how of our employees, significant progress has been made with helping staff plan their careers and the management of talent. To encourage and recognise achievement, we have adopted a performance-based reward system.

In acknowledgment of our focus on staff training, we won a bronze award and a certificate of excellence at the Excellence in Training Awards 2006 organised by the Hong Kong Management Association.

Corporate social responsibility

Our business relies on the strong support of the local communities in which we operate. We give back to these communities not only by providing world-class banking services but also through involvement in social and environmental initiatives.

The support of education is one of the most important ways in which we contribute to the development of society. Since 1995, we have allocated HK$49 million to help 964 students further their tertiary studies.

With Hang Seng as principal sponsor, more than 60 of our senior executives have contributed their time to Junior Achievement Hong Kong's New Leaders Programme, which aims to inspire ethical leadership and promote sound values among young people.

In June, our "Hang Seng Bank – Junior Police Call Environmental Detectives" competition, designed to promote environmental awareness, received the Gold Award in Community Relations from the China International Public Relations Association.

We remain committed to minimising any negative environmental impact of our business.

More than 100,000 personal account holders now use our e-Statement service under which they can view their bank statements online at any time, saving an estimated 5 million sheets of A4 paper a year.

In January, we pledged to plant one tree for every shareholder who elected to receive shareholder communication materials by electronic means and for every 10 Hang Seng personal accounts that switched to e-Statement, up to a total of 10,000 trees. Over 2,000 shareholders have since opted to receive materials electronically. In April, 10,000 saplings were planted at Ma On Shan Country Park, bringing the number of trees we have planted since 1999 to 50,000.

Further details of our beliefs and activities as a good corporate citizen can be found in our 2005 Corporate Social Responsibility report, available at http://www.hangseng.com/hsb/eng/abo/cc/csr/csr_report.html.

The road ahead

The good economic conditions and strong labour market are forecast to continue during the second half of the year, although the pace of growth may become more moderate if uncertainty over global interest rate trends persists.

We will take advantage of positive market sentiment to grow commercial lending and consumer finance and expand the reach of our SME services. We will build on the success of our wealth management business by continuing to introduce products that meet the demands of a wide spectrum of investors.

On the Mainland, we will further extend our reach with the opening of our first sub-branch in Guangzhou next month and a branch in Dongguan later this year. We will take additional steps to expand our deposit base to support loan growth. We have applied for a licence under the Qualified Domestic Institutional Investors scheme and will continue to develop our wealth management services.

Progress under our roadmap for growth has helped us return solid results in the first half of 2006 and provides a good foundation from which to further build our business. Backed by our strong brand, we remain firmly focused on our objectives to the sustaining benefit of our business and stakeholders.

Raymond Or
Vice-Chairman and Chief Executive
Hong Kong, 31 July 2006