

# CHIEF EXECUTIVE'S REPORT

The first half of 2006 was marked by the commencement of the Group's Strategic Plan 2006-2011. Given our clearly defined goals and the strengths we have built up in recent years, I am pleased that we have been able to move ahead with a stronger focus to create higher value for stakeholders.

The Group's business performance in the interim period was encouraging. Substantial growth was achieved in total operating income, operating profit and profit attributable to shareholders respectively. In the following sections, I will explain in detail how these results were a fair reflection of the solid progress we have made in implementing the strategies announced in March this year that enabled us to live up to our promises and standards.

Aside from the acquisition of BOC Life which enhances our capability to capitalise on the Group's powerful customer base to grow life insurance income, we have moved forward with the strategy to drive organic growth by focusing on higher-yielding segments, including wealth management, cash management, treasury products and SME loans, through cross-selling, customisation and product innovation. At the same time, we have maintained our leading positions in areas where we have an edge, including corporate lending and Renminbi (RMB) banking services. Our position in the Mainland market and our capability in offering cross-border services have also been further reinforced.

## Performance Highlights

The Group's solid financial performance was underpinned by a positive market environment with increased investment and domestic consumption on the one hand and, more importantly, by the initiatives we have taken to put into practice our Strategic Plan 2006-2011 on the other.

The Group's total operating income, which reflects our capability in driving business growth, continued to grow strongly in the first six months of 2006. Compared to the same period last year, net operating income before loan impairment allowances was up nearly 27% to HK\$10,517 million, the highest interim figure since the Group's IPO in 2002. Operating profit was up by a

healthy 16.1% to HK\$8,188 million although loan impairment allowance write-back, at HK\$642 million, was 55.3% lower than the same period of 2005. On the other hand, in line with the property market trend under which property prices rose only moderately, the Group's net gain of investment properties revaluation dropped by 48% to HK\$477 million. Notwithstanding these two factors, which had contributed significantly to our net profit in the first half of 2005, we still managed to grow our profit attributable to shareholders by 8.4% to HK\$7,093 million - another interim record for the Group so far. Earnings per share increased by 8.4% to HK\$0.6709.

Return on average total assets remained at 1.59% whereas return on average shareholders' funds was down marginally by 0.72 percentage point to 17.63% year-on-year.

The Group's net interest income increased substantially by over 26% to HK\$7,573 million. Average interest-earning assets were up 10.4% to HK\$827,948 million due mainly to the increase in average deposits and IPO-related funds. At the same time, we have been able to widen our overall net interest margin to 1.84%, up 23 basis points from a year ago.

It should be highlighted that our gross yield on average loans increased by 247 basis points year-on-year as a result of our conscious effort in maintaining loan spreads amid keen competition in a rising interest rate environment. Gross yields on debt securities also increased by 152 basis points as the Group continued to diversify its investment portfolio to enhance return.

After the robust growth in fiscal 2005, total loans and advances to customers stayed flat at HK\$333,208 million. Residential mortgage loans decreased as a result of intense competition in a relatively quiet property market and our policy to maintain reasonable yield. Corporate loans and loans for use outside Hong Kong increased moderately.

Net fees and commission income rose by 21.2% to HK\$1,761 million due to the strong growth in stockbroking and asset management by 95.2% and



60.6% respectively. Net trading income declined by 13.3%. While net trading income from foreign exchange and related products increased by 27.2%, that from interest rate instruments posted a net loss due to the adverse effect of rising interest rates on the fair value of certain financial assets.

Net insurance premium income nearly doubled vis-à-vis the same period last year, driven primarily by the solid growth in both the number of policies concluded and premium per new policy.

The Group's operating expenses were up 10.3% mainly as a reflection of the increase in staff salary. The cost-to-income ratio improved considerably to 28.25%, compared to 32.40% a year ago, thanks to the substantial growth in operating income.

Given the market conditions and our effective risk management, the Group's asset quality improved further. Impaired loan ratio continued to drop in the first half of 2006, down to 1.09% from 1.28% six months ago.

The Group maintained strong capital and liquidity positions. Consolidated capital adequacy ratio was 14.61% as at the end of June, down 0.76 percentage point from end-2005 due to an increase of 6.7% in total risk-weighted assets as a result of higher securities investment. Average liquidity ratio rose to 50.3% from 42.02% of six months ago.

## Business Review

In the course of implementing our current Strategic Plan, we have striven to enhance our competencies to provide superior service to customers while generating higher yield and profitability. Our business and financial performance in the interim period was a good indication of our success in that approach.

### Retail Banking

Retail banking continued to generate good business results for the Group in spite of fierce competition in the market. We have been able to tap the potentials of our strong and loyal customer base as well as extensive branch network in Hong Kong to grow our retail segment on a continuous basis.

Net operating income before loan impairment allowances rose by 13.0% to HK\$5,482 million, of which net interest income was up 4.4% to HK\$3,812 million and other operating income was up a much stronger 38.9% to HK\$1,670 million. Profit before taxation increased by 14.1% year-on-year to HK\$3,189 million.

Net interest income continued to grow as the interest rate hike brought higher returns of prime-based loans on the one hand and the Group succeeded in managing the cost of funding on the other. Our efforts in improving asset and liability management have proved to be effective. The illustrious growth in other operating income was attributable to the hefty increase in net fees and commissions of 42.2% as a result of an active stock market coupled with the spate of IPOs in the first half of the year. Our stock brokerage business volume soared by 121.6% year-on-year.

The number of wealth management customers and the amount of assets under management increased by 24.7% and 20.1% respectively from end-2005. In collaboration with BOC, our parent bank, we launched in December 2005 the cross-border service for wealth management customers of both banks, enabling them to enjoy priority and privileged banking services at the designated branches of BOCHK and BOC wherever they are in Hong Kong, the Mainland of China or other major cities in the Asia Pacific region. The introduction of this service truly reflects the unique edges enjoyed by both banks.

For the reasons already mentioned above, the Group's residential mortgage business consolidated in the first half of 2006. The credit quality of residential mortgage, however, improved further amid the upturn of the local economy.

The Group's credit card business continued to grow. Cardholder spending and merchant acquiring volume rose by 7.2% and 15.0% respectively. In the interim period, we launched GBP Greatwall International Card. The Group also became the first EMV certificate acquirer in Hong Kong.

The Group maintained its market leadership in RMB banking business with a broader range of related services. As the leader in RMB card issuance, we grew the volume of RMB card business substantially by 60.3%. In March 2006, the Group became the first local bank to roll out personal RMB chequing service.

### **Corporate Banking**

Corporate banking registered steady business growth in the first half. Net operating income before loan impairment allowances rose by over 10% to HK\$2,516 million, of which net interest income and other operating income were up 11.5% and 5.9% respectively.

Profit before taxation dropped by 19.3% to HK\$2,445 million mainly because of a 55.3% reduction in net release of loan impairment as significant improvement had been made in our corporate loan quality over the years. The Group remained a major market player in arranging syndicated loans in the Hong Kong-Macau-Mainland market.

In line with our goal, the emphasis of the Group's corporate banking business has been on adjusting business structure and customer mix to concentrate on high-value and high-margin segments. We have formulated a 5-year SME business plan which focuses on further improving SME business model, optimising credit approval procedures for SME loans, simplifying existing workflow, and increasing efficiency of customer service. That, coupled with the introduction of relevant new products, contributed to a 3% increase in SME loans in the interim period. The Group's cash management system has also been extended to cover more BOC's overseas branches.

### **Mainland Business**

Our Mainland branches continued to deliver higher profit in the first half of 2006. While total advances increased only marginally as a result of early loan repayment by some large corporate clients in the Mainland, operating profit before loan impairment allowances rose by 5.6% to HK\$150 million due mainly to larger average loan size.

In the interim period, two more branches were approved to conduct RMB business. In other words, 11 of the Group's branches and sub-branches can now offer RMB-related banking services in the Mainland. Besides, all of our 14 branches and sub-branches are licensed to provide insurance agency services. We have also extended our wealth management products to the Mainland market. Meanwhile, we have applied for permission to conduct overseas treasury management business to prepare for the implementation of QDII.

### **Treasury**

Treasury's profit before taxation rose by 169.5% year-on-year, reaching HK\$2,606 million. Net interest income and other operating income soared by 265.5% and 46.4% to HK\$2,076 million and HK\$719 million respectively. The substantial growth in net interest income was driven mainly by higher contribution of net free fund and better return on debt securities portfolio.

To capture the demand arising from the increasing popularity of investment products with steady income, the Group successfully launched an array of new treasury products. These included structured deposits linked with interest rates, foreign exchange rates and bullion prices which were well-received by customers. The treasury marketing unit which was established towards the end of 2005 has been active in providing customised services to local and Mainland customers through cross-selling between the retail and corporate banking units. In the interim period, the number of treasury customers increased by 12.3%.

As interest rates rose further, the Group continued to diversify its investments to maximise the return on residual funds while mitigating the concentration risk.

### **Insurance**

Upon acquiring BOC Life in June 2006, we have adopted merger accounting in presenting the Group's 2006 mid-year results. On a comparative basis, the insurance segment recorded a growth of over 68.1% year-on-year in profit before taxation to HK\$79 million. Net interest income rose 47.5% to HK\$208 million while other operating income registered a growth of 75% to



HK\$2,958 million due to higher insurance premium after the successful launch of a number of insurance products in the first half of the year.

### Prospects and Strategies

While we are optimistic that the economic climate should remain positive in the latter half of 2006, there are challenges that should not be overlooked. In the local market, competition is likely to intensify as banks scramble for quality customers and business with new products and service arrangements. Externally, the US interest rate hike has already shown signs of peaking but uncertainties such as volatile oil prices and geopolitical conflicts may adversely affect trade prospects and investment sentiments.

On our part, we will forge ahead with the implementation of the Group's Strategic Plan 2006-2011.

First, we will carry out and further enhance our RPC (Relationship-Product-Channel) Model, which will help strengthen our leading position in Hong Kong. With the establishment of a broader-based and upgraded customer relationship management platform, we now have teams of dedicated and professional relationship managers to drive organic business growth. As our product management system improves further, we are in a better position to develop and expand the range of products and services that are tailored the needs of different customer segments. At the same time, we will continue to optimise our channels and workflow to facilitate sales and marketing. Where necessary, we are ready to invest in more manpower and IT infrastructure to support the RPC Model.

Secondly, we are going to strengthen our development in the Mainland and other parts of the region. We will actively seek out new opportunities for expansion in southern and eastern China. We will also continue to collaborate closely with BOC to grow our Mainland and cross-border businesses.

Thirdly, we will remain alert to new acquisition opportunities to equip ourselves with additional capabilities. The recent acquisition of BOC Life is the

first significant step to enhance our product manufacturing capabilities and new business lines, which will enable us to move further up the value chain, diversify our income base, raise our overall profit margin and become a full-fledged financial services group.

Fourthly, in anticipation of the further opening of RMB banking business and to prepare ourselves for new business opportunities such as QDII and CIBM, we are ready to invest in the necessary infrastructure and formulate relevant measures to ensure our advantageous position in the market.

Last but not the least, we will continue to promote our corporate culture and values across the Group as an integral part of our Strategic Plan. To be customer's premier bank, we will entrench our customer-centric culture internally so that as a team we can work together to deliver superior services to customers and higher value to shareholders. We will continue to invest in human resources and improve our staff remuneration system for we believe that a committed workforce is crucial for sustaining long-term growth. We also believe that a rewarding career is essential for encouraging performance, innovation and high ethical standards among the staff.

To conclude, I wish to stress that the first half of 2006 has been an excellent start insofar as the implementation of Strategic Plan 2006-2011 is concerned. With the guidance of the Board and the dedication of our staff, I am sure we can confidently live up to our goals of maximising shareholder value and evolving into a full-fledged financial services group.



**HE Guangbei**

Vice Chairman & Chief Executive

Hong Kong, 29 August 2006