Build

customer satisfaction and provide quality and professional service

Through the *BOCHK Wealth Management Investment Seminar*,
customers could have a better understanding of our financial and investment products

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section provides an analysis of the Group's performance, financial position, and risk management. The following analysis should be read in conjunction with the financial statements included in this Annual Report. The Group has applied the merger accounting method in accounting for the combination with BOC Life on 1 June 2006. As a result, the 2005 comparative figures were restated as appropriate.

PERFORMANCE MEASUREMENT

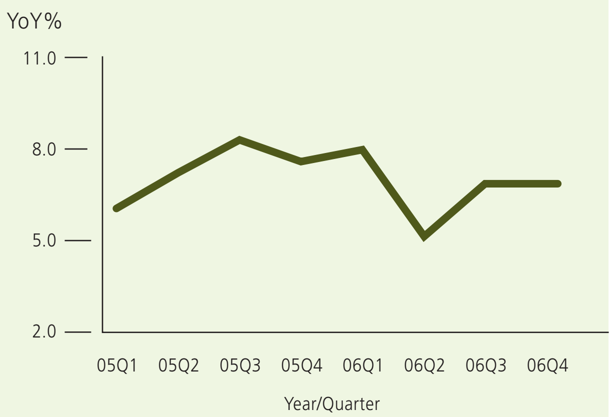
The Group registered record earnings in 2006. This was essentially the result of the Group's strong and broad-based business growth achieved through the effective execution of growth strategies and initiatives. The following table summarises the Group's overall performance in 2006.

Financial Indicators	Performance	Result Highlights
ROE[1] and ROA[2]	• Operating profit before loan impairment allowances increased by 18.9% to HK$14,751 million. • Profit attributable to shareholders increased by 3.0% to HK$14,007 million. • ROE and ROA were 17.02% and 1.56% respectively. • ROE and ROA before loan impairment allowances rose by 1.25 percentage points and 0.12 percentage point respectively to 17.92% and 1.61% respectively.	• Operating profit before loan impairment allowances increased by 18.9% and profit attributable to shareholders rose by 3.0% • ROE: 17.02% • ROA: 1.56%
Dividend payout ratio	The proposed final dividend plus interim dividend represent a total payout ratio of 64.01%, which is within the range set out in the Group's dividend policy.	• Dividend payout ratio: 64.01%
Interest margin and non-interest income[3]	• Net interest margin rose from 1.72% in 2005 to 1.90% in 2006 mainly due to the rise in contribution from net free fund. • Non-interest income increased by 8.4%, primarily driven by investment-related agency fee income. Non-interest income to total operating income ratio decreased by 2.10 percentage points to 25.69% due to a larger increase in net interest income relative to non-interest income.	• Net interest margin: 1.90% • Non-interest income to total operating income ratio: 25.69%
Cost efficiency	Cost-to-income ratio was further lowered by 0.97 percentage point to 30.78% mainly due to a faster increase in operating income than operating expenses. Total income increased by 17.2% while operating expenses increased by 13.6%.	• Cost-to-income ratio: 30.78%
Asset quality	• Formation of new classified loans[4] remained at a low level of 0.3% of total loans. Classified loan ratio fell significantly by 0.71 percentage point from 1.28% in 2005 to 0.57% in 2006. • Impaired loan[5] ratio declined by 0.30 percentage point to 0.26% at end-2006.	• Classified loan ratio: 0.57% • Impaired loan ratio: 0.26%
Capital strength and liquidity	Capital adequacy ratio and liquidity ratio remained strong.	• Capital adequacy ratio: 13.99% • Liquidity ratio: 50.46%

(1) ROE represents return on average capital and reserves attributable to the equity holders of the Company.
(2) ROA represents return on average total assets and is defined in "Financial Highlights".
(3) Non-interest income represents net fees and commission income, net trading income, net loss on investments in securities, net insurance premium, other operating income and net insurance benefits and claims.
(4) Classified loans are advances to customers which have been classified as "substandard", "doubtful" and "loss" under the Group's classification of loan quality.
(5) Impaired loans are advances where objective evidence exists that full repayment of principal or interest is considered unlikely.

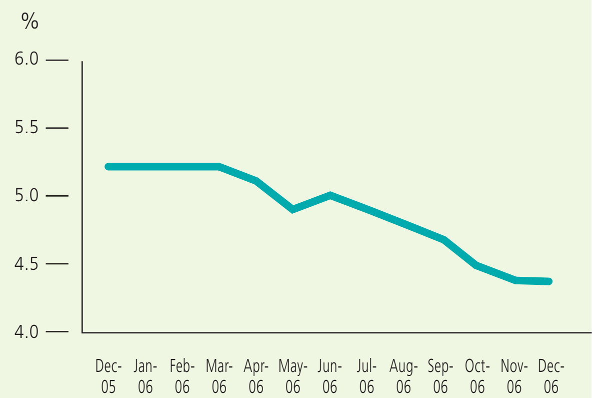
BUSINESS ENVIRONMENT

Hong Kong Real GDP



Source: Bloomberg

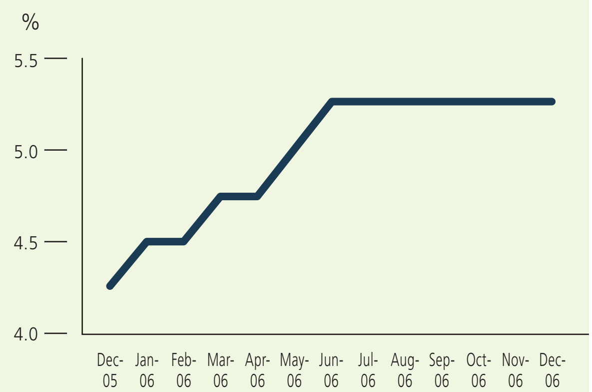
Hong Kong Unemployment Rate



Source: Bloomberg

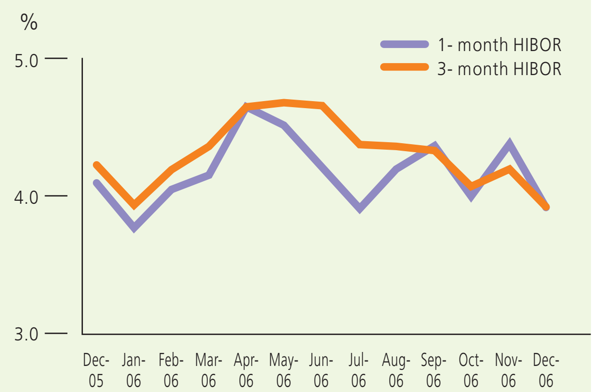
In 2006, the operating environment remained largely positive. Bolstered by active investment, strong domestic consumption and robust external trade, the Hong Kong economy registered above-the-trend growth for the third consecutive year. Hong Kong's real GDP growth reached 6.8%. Inflation remained mild with the composite consumer price index on average 2.0% higher than 2005. The labour market improved further with the unemployment rate dropping to 4.4% by year end.

Federal Funds Target Rate



Source: Bloomberg

HIBOR

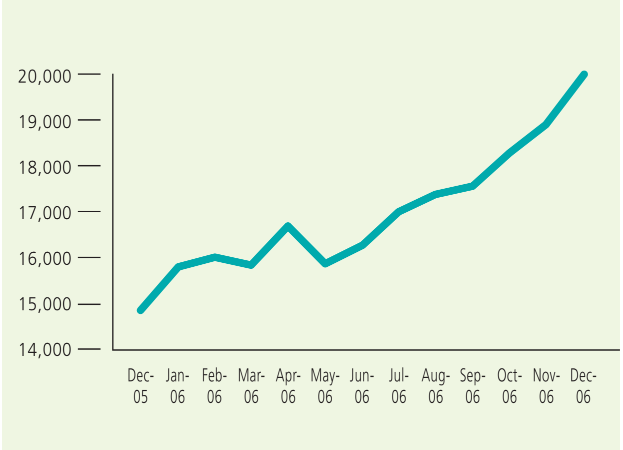


Source: Bloomberg

During the first half of 2006, the US Federal Funds Target Rate was raised by an aggregate of 100 basis points to 5.25%. In line with the US interest rate hike, both average 1-month and 3-month HIBOR increased. In the second half of 2006, despite the existence of inflationary pressure, the US Federal Funds Rate levelled off due to the softening economy. On the other hand, both average 1-month and 3-month HIBOR declined in view of abundant liquidity in the local banking sector. The yield curve flattened, as evidenced by the narrowing of the average interest spread between 2-year Exchange Fund notes and its 10-year counterparts from 82 basis points to 31 basis points at end-2006 which compressed the reinvestment return on debt securities.

The interest rate differential between USD and HKD widened in 2006. In 2006, the Group's average HKD Prime rates increased by 186 basis points compared to the previous year whereas the average US Federal Funds Rate increased by 176 basis points for the same period. Meanwhile, the average HKD 1-month HIBOR and 1-month USD LIBOR for 2006 increased by 118 basis points and 171 basis points respectively.

Hang Seng Index



Source: Bloomberg

The local stock market was buoyant in 2006 amidst ample liquidity. Market sentiments were further boosted by the enthusiastic response to the spate of major IPOs, especially in the second half of the year. The total fund raised by IPOs in 2006 was HK$334bn, more than double that of 2005. The Hang Seng Index surged by 34.2% to close at 19,964.72 points at end-December 2006. The robust stock market helped boost the equity investment and IPO-related businesses of the banking sector.

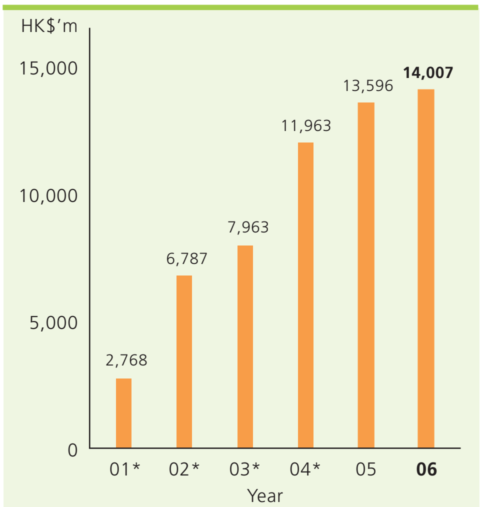
After a relatively quiet first half, the local property market regained some growth momentum in the second half of 2006. The number of transactions increased as US interest rates appeared to have peaked in the latter half of 2006. Intensified market competition, however, meant greater downward pressure on mortgage yield. HIBOR-linked mortgage plans became more popular as the 1-month HIBOR remained at a relatively low level throughout the year.

In 2006, the local banking sector continued to operate under a benign credit environment. The classified loan ratio of retail banks as a whole improved from 1.37% at end-2005 to 1.11% at end-2006. Overall, the local banking sector was able to benefit from the continuous economic growth, buoyant investment markets and improved asset quality, but at the same time, faced challenges from intensified market competition and limited local lending opportunities.

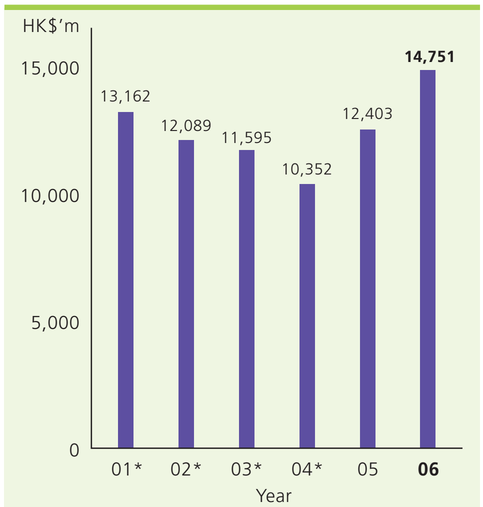
CONSOLIDATED FINANCIAL REVIEW

The Group's financial performance in 2006 was satisfactory. Both operating profit before loan impairment allowances and profit attributable to shareholders reached record highs. In view of the Group's strong core earnings growth, operating profit before loan impairment allowances increased by HK$2,348 million, or 18.9%, to HK$14,751 million. Despite a fall in both loan impairment allowances write-back (loan impairment allowances write-back was mainly due to loan recoveries) and investment property revaluation gain, profit attributable to shareholders increased by HK$411 million, or 3.0%, to HK$14,007 million. Earnings per share were HK$1.3248, up HK$0.0389. Return on average total assets ("ROA") and return on average shareholders' funds ("ROE") were 1.56% and 17.02% respectively. By comparison, ROA and ROE appeared lower in 2006 because of the relatively high loan impairment allowances write-back and revaluation gain on investment properties recorded in 2005. Indeed, ROA and ROE before loan impairment allowances in 2006 improved by 0.12 percentage point and 1.25 percentage points to 1.61% and 17.92% respectively over 2005.

Profit attributable to equity holders



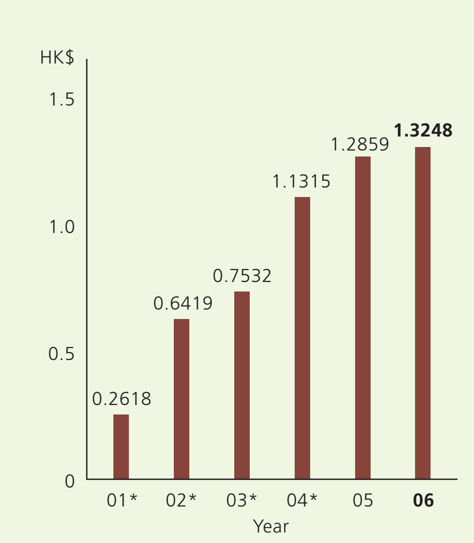
Operating profit before loan impairment allowances



* Excluding BOC Life

Dividend per share

Earnings per share



* Excluding BOC Life

Financial Highlights

HK$'m, except percentage amounts	2006	Restated 2005
Operating income	**21,309**	18,174
Operating expenses	**(6,558)**	(5,771)
Operating profit before loan impairment allowances	**14,751**	12,403
Reversal of loan impairment allowances	**1,790**	2,645
Others	**598**	1,454
Profit before taxation	**17,139**	16,502
Profit attributable to equity holders of the Company	**14,007**	13,596
Earnings per share (HK$)	**1.3248**	1.2859
Return on average total assets	**1.56%**	1.67%
Return on average shareholders' funds*	**17.02%**	18.27%
Return on average total assets before loan impairment allowances	**1.61%**	1.49%
Return on average shareholders' funds before loan impairment allowances*	**17.92%**	16.67%
Net interest margin	**1.90%**	1.72%
Non-interest income ratio	**25.69%**	27.79%
Cost-to-income ratio	**30.78%**	31.75%

* Shareholders' funds represent capital and reserves attributable to the equity holders of the Company.

Analyses of the financial performance and business operations of the Group for 2006 are set out in the following sections.

Net Interest Income and Margin

HK$'m, except percentage amounts	**2006**	2005
Interest income	**40,271**	26,177
Interest expense	**(24,436)**	(13,053)
Net interest income	**15,835**	13,124
Average interest-earning assets	**835,493**	760,914
Net interest spread	**1.47%**	1.47%
Net interest margin	**1.90%**	1.72%

In 2006, net interest income increased by HK$2,711 million, or 20.7%, to HK$15,835 million. Average interest-earning assets grew by HK$74,579 million, or 9.8%, to HK$835,493 million, due to the increase in deposits (including funds from IPO subscription). Net interest margin increased by 18 basis points to 1.90% while net interest spread remained flat. Contribution from net free fund rose by 18 basis points because of rising interest rates.

Market interest rates were higher in 2006 than in 2005. After the refinement of the operation of the linked exchange rate mechanism by the HKSAR government in May 2005, one-month HIBOR mounted from 1.96% at end-April 2005 to 4.10% at end-2005, culminating at 4.68% in May 2006. Starting from the second half of 2006, it dropped gradually, falling to 3.87% in mid-August and then remaining relatively stable at the average of 4.05% in the fourth quarter. On the other hand, LIBOR rates behaved quite differently – One-month LIBOR increased and peaked in August 2006 at 5.42% and remained relatively flat till end-2006. Average one-month HIBOR increased by 118 basis points to 4.12% as compared to 2.94% a year ago while average one-month LIBOR increased by 171 basis points to 5.10% during the same period. The Group's average HKD Prime rate rose to 8.03% in 2006, compared to 6.17% a year ago, thus widening the HKD Prime-to-one-month HIBOR spread (hereinafter called "Prime-HIBOR spread") by 68 basis points to 3.91%.

The increase in net interest income was mainly driven by the growth of interest-earning assets and contribution of net free funds. For 2006, the Group's average gross yield on loans and advances to customers increased by 157 basis points to 5.65%. This was attributable to higher market interest rates and the increase in higher yielding loans such as credit cards receivable and the lending business of Mainland branches. Although the weighted average yield on residential mortgage portfolio, excluding Government Home Ownership Scheme ("GHOS") mortgages, decreased by 12 basis points year on year to 2.56% from 2.44% below HKD Prime rate, overall loan spread improved as a result of widening of Prime-HIBOR spread. The Group continued to diversify its investment portfolio effectively. By increasing its investments in asset-backed securities, mortgage-backed securities and corporate bonds, the Group raised its gross yield on debt securities by 126 basis points. However, improvement in net contribution from the debt securities portfolio was held back by the flattening yield curve. Fixed deposit spread widened as a result of the Group's conscious effort in managing funding costs. On the other hand, higher deposit rates and the increase in average fixed deposits led to higher overall funding cost. For instance, average interest rates on savings and fixed deposits increased by 159 basis points and 119 basis points respectively.

The summary below shows the average balances and average interest rates of individual assets and liabilities:

ASSETS

	Year ended 31 December 2006		Restated Year ended 31 December 2005	
	Average balance HK$'m	**Average yield %**	Average balance HK$'m	Average yield %
Loans to banks	**177,465**	**3.90**	166,224	2.38
Debt securities investments	**302,349**	**4.60**	251,424	3.34
Loans and advances to customers	**333,901**	**5.65**	323,359	4.08
Other interest-earning assets	**21,778**	**2.63**	19,907	3.21
Total interest-earning assets	**835,493**	**4.82**	760,914	3.44
Non interest-earning assets	**80,407**	**–**	70,875	–
Total assets	**915,900**	**4.40**	831,789	3.15

LIABILITIES

	Year ended 31 December 2006		Restated Year ended 31 December 2005	
	Average balance HK$'m	**Average rate %**	Average balance HK$'m	Average rate %
Deposits and balances of banks and other financial institutions	**44,859**	**2.99**	33,865	2.21
Current, savings and fixed deposits	**653,237**	**3.35**	597,279	1.93
Certificate of deposits issued	**3,484**	**3.22**	3,800	2.94
Other interest-bearing liabilities	**28,232**	**3.78**	27,374	2.35
Total interest-bearing liabilities	**729,812**	**3.35**	662,318	1.97
Non interest-bearing deposits	**32,807**	**–**	33,911	–
Shareholders' funds* and non interest-bearing liabilities	**153,281**	**–**	135,560	–
Total liabilities	**915,900**	**2.67**	831,789	1.57

* Shareholders' funds represent capital and reserves attributable to the equity holders of the Company.

Second Half Performance

Compared to the first half of 2006, net interest income increased by HK$827 million, or 11.0 %, in the second half. Average interest-earning assets grew by HK$3,266 million, or 0.4%. Net interest margin and net interest spread rose by 16 basis points and 15 basis points respectively. Contribution from net free funds rose by 1 basis point.

Following a relatively steep rise in the first half of 2006, market interest rates became more stable in the second half. Because of higher liquidity in the market, average one-month HIBOR declined in the second half by 15 basis points vis-à-vis the first half of 2006. Meanwhile, average one-month LIBOR increased by only 49 basis points. Consequently, improvement in the contribution of net free fund slowed down. The Group continued to benefit from diversification of debt securities holding with gross yield on debt securities rose by 41 basis points. Moreover, as the Group's higher yielding loans increased and Prime-to-HIBOR spread widened, loan spread improved. Weighted average yield from the residential mortgage portfolio, excluding GHOS mortgages, declined by 8 basis points to 2.60% below the HKD Prime rate. Total deposit spread widened as savings rate decreased coupled with higher average market rates.

Net Fees and Commission Income

HK$'m	**2006**	2005
Bills commissions	**537**	532
Loan commissions	**273**	263
Investment and insurance fee income	**1,851**	1,139
Securities brokerage (Stockbroking)	**1,383**	714
Securities brokerage (Bonds)	**105**	120
Asset management	**317**	203
Life insurance	**46**	102
General insurance	**96**	103
Trust services	**118**	107
Payment services	**418**	381
Credit cards	**807**	737
Account services	**304**	298
Guarantees	**44**	43
Currency exchange	**117**	102
RMB business	**77**	43
Correspondent banking	**31**	19
IPO-related business	**60**	12
Others	**252**	227
Fees and commission income	**4,985**	4,006
Fees and commission expenses	**(1,268)**	(1,061)
Net fees and commission income	**3,717**	2,945

Net fees and commission income increased by HK$772 million, or 26.2%, to HK$3,717 million mainly due to the significant increase in commissions from stock brokerage of HK$669 million or 93.7% and in asset management fee income of HK$114 million or 56.2%. The buoyant equity market and IPO activities helped boost stock transactions. With its newly launched eIPO services and IPO promotion programmes, the Group grew its stock brokerage business volume substantially by 112%. At the same time, the sales of open-end funds also rose by 90.0%. However, the sales of structured notes declined and the income derived therefrom was down by HK$15 million or 12.5%. Moreover, as a result of the combination with BOC Life, fee income from life insurance only included that from the Group's other insurance business partner after group consolidation elimination. It fell by HK$56 million, or 54.9%, mainly due to competition. Fees from card business recorded a growth of 9.5%, as cardholder spending and merchant acquisition volume increased by 13.7% and 22.5% respectively. Fees from trust services and payment services grew by 10.3% and 9.7% respectively. Riding on the active IPO activities, the Group's fees income from IPO-related activities such as receiving banker's fee and brokerage surged by HK$48 million or a fourfold growth. Meanwhile, RMB-related services also rose by HK$34 million or 79.1%. Fees and commission expenses rose by HK$207 million or 19.5% as the Group continued to expand its stock brokerage, credit card and RMB-related businesses. Moreover, additional charges under the Deposit Protection Scheme that commenced in September 2006 also contributed to the increase in fees and commission expenses.

Second Half Performance

Compared to the first half of 2006, net fees and commission income increased by HK$195 million, or 11.1%, in the second half. The active Hong Kong stock market helped boost the Group's fee income from stock brokerage by HK$95 million, or 14.8%. Fee income from bond sales surged by HK$47 million, or 162.1%, which was in line with the increase in the sales volume of retail bonds. Loan commissions grew by HK$41 million, or 35.3%, due to higher business volume. Fees from card business, trust services and bills commissions also increased by 15.2%, 18.5% and 7.3% respectively. Fees and commission expenses in this period rose by HK$86 million, or 14.6%, mainly due to increase in stock brokerage, credit card expenses and the additional charges under the Deposit Protection Scheme.

Investment and Insurance Business

HK$'m	**2006**	2005
Investment and insurance fee income		
Securities brokerage (Stockbroking)	**1,383**	714
Securities brokerage (Bonds)	**105**	120
Asset management	**317**	183
Life insurance	**46**	102
	1,851	1,119
Insurance and investment income of BOC Life		
Net insurance premium income	**6,195**	3,630
Interest income	**473**	318
Net trading income	**420**	(305)
Fee income – asset management	**–**	20
Others	**6**	3
Gross insurance and investment income of BOC Life*	**7,094**	3,666
Less: net insurance benefits and claims	**(6,655)**	(3,362)
	439	304
Total investment and insurance income	**2,290**	1,423

* Before commission expenses.

In 2006, total investment and insurance income surged by HK$867 million, or 60.9%, to HK$2,290 million, primarily due to an increase in investment and insurance fee income of HK$732 million, or 65.4%, and the rise in BOC Life's insurance and investment income by HK$135 million, or 44.4%. The increase in BOC Life's insurance and investment income was mainly attributable to higher interest income from securities investments as a result of the significant growth of premium income and an increase in net trading income, partly offset by a growth in net insurance benefits and claims.

Second Half Performance

Compared to the first half of 2006, total investment and insurance income increased by HK$156 million, or 14.6%, mainly due to an increase in investment and insurance fee income of HK$135 million, or 15.7%. Insurance and investment income of BOC Life grew by HK$21 million, or 10.0%.

Net Trading Income

HK$'m	**2006**	2005
Net trading income of the banking business		
Foreign exchange and foreign exchange products	**1,113**	1,414
Interest rate instruments	**204**	277
Equity instruments	**73**	8
Commodities	**78**	52
	1,468	1,751
Net trading income of BOC Life		
Foreign exchange and foreign exchange products	**1**	–
Interest rate instruments	**359**	(317)
Equity instruments	**60**	12
Commodities	**–**	–
	420	(305)
Total net trading income	**1,888**	1,446

Net trading income registered a gain of HK$1,888 million in 2006, of which HK$1,468 million was derived from the Group's banking business and HK$420 million came from BOC Life. The net trading income of the banking business decreased by HK$283 million, or 16.2%, mainly because of the decline in net trading income from foreign exchange and foreign exchange related products of HK$301 million, or 21.3%. The decline was caused by the decrease in net trading income from foreign exchange swap contracts. Net trading income from interest rate instruments also dropped by HK$73 million due to the decline in the fair value of the Group's interest rate swap contracts, which was partly offset by the increase in net trading income from equity instruments and commodities. Net trading income of BOC Life was up by HK$725 million, compared to a net loss of HK$305 million in 2005. The rise in net trading income was mainly driven by an increase of HK$676 million in net trading income from interest rate instruments and an increase of HK$48 million in net trading income from equity instruments. Net trading income from interest rate instruments posted a net gain of HK$359 million, versus a net loss of HK$317 million in 2005. This gain was mainly attributable to the favourable changes in the fair value of securities investments and the structured notes held by BOC Life.

Second Half Performance

Compared to the first half of 2006, net trading income rose by HK$490 million or 70.1% in the second half mainly due to an increase in the fair value of the securities investments and structured notes held by BOC Life. The increase was partly offset by the decline in net trading income from foreign exchange swap contracts and the decrease in the fair value of interest rate swap contracts of the banking business.

Net Insurance Premium Income

HK$'m	**2006**	2005
Life and Annuity	**5,855**	3,216
Linked Long Term	**348**	419
Retirement Scheme	**–**	1
	6,203	3,636
Reinsurers' share of gross earned premiums	**(8)**	(6)
Net insurance premium income	**6,195**	3,630

Compared to 2005, net insurance premium income registered a solid growth of HK$2,565 million, or 70.7%, to HK$6,195 million. This growth was driven by the 58.5% growth in the number of new insurance policies concluded. The strong growth of premium income was the result of satisfactory sales of new life insurance products introduced during the year.

Second Half Performance

Compared to the first half of 2006, net insurance premium income decreased by HK$757 million or 21.8% to HK$2,719 million. The decline was mainly due to comparatively lower sales of policies after a strong first half.

Net Insurance Benefits and Claims		
HK$'m	**2006**	2005
Life and Annuity	**6,309**	2,965
Linked Long Term	**344**	397
Retirement Scheme	**3**	1
	6,656	3,363
Reinsurers' share of claims, benefits and surrenders paid and movement in liabilities	**(1)**	(1)
Net insurance benefits and claims	**6,655**	3,362

Compared to 2005, net insurance benefits and claims increased by HK$3,293 million or 97.9% to HK$6,655 million mainly due to growth of the life and annuity insurance underwriting business. Prospective liabilities were recognised on the basis of the assumptions made as to mortality, investment income and fair value changes in the underlying investments.

Second Half Performance

Compared to the first half of 2006, net insurance benefits and claims increased by HK$535 million or 17.5% to HK$3,595 million in the second half, mainly due to increase in new business.

Operating Expenses		
HK$'m, except percentage amounts	**2006**	2005
Staff costs	**4,004**	3,493
Premises and equipment expenses (excluding depreciation)	**868**	740
Depreciation on owned fixed assets	**671**	568
Other operating expenses	**1,015**	970
Operating expenses	**6,558**	5,771
Cost to income ratio	**30.78%**	31.75%

In line with overall business expansion, the Group's operating expenses increased by HK$787 million, or 13.6%, to HK$6,558 million. Staff costs rose by HK$511 million or 14.6% following the pay rise in April 2006 and the recruitment of new staff needed by the Group. Compared to end-2005, headcount measured in full-time equivalents rose by 65 from 12,933 to 12,998 at end-2006.

Premises and equipment expenses increased by HK$128 million or 17.3% primarily due to higher rental and IT costs incurred.

Depreciation on owned fixed assets rose by HK$103 million, or 18.1%, to HK$671 million in 2006 largely due to appreciation of the value of bank premises.

Second Half Performance

Compared to the first half of 2006, operating expenses rose by HK$616 million or 20.7%. This was basically in line with the normal seasonal trend, in particular, salary adjustments began from the second quarter of each year.

Reversal of Loan Impairment Allowances on Advances

HK$'m	**2006**	2005
Reversal of/(Charge for) loan impairment allowances		
Individual assessment		
– new allowances	**(647)**	(1,304)
– releases	**313**	1,042
– recoveries	**2,053**	1,639
Collective assessment		
– new allowances	**(194)**	(11)
– releases	**203**	1,279
– recoveries	**62**	–
Net credit to Income Statement	**1,790**	2,645

The Group recorded a net release of loan impairment allowances of HK$1,790 million in 2006, primarily due to loan recoveries. Compared to 2005, net release of loan impairment allowance was down HK$855 million or 32.3%, mainly caused by a decline in release of allowances.

Net impairment charge on individual assessment increased by HK$72 million due to lower release of allowances. The significant release in 2005 was mainly attributable to the recovery of a large account. Additional allowances amounting to HK$647 million, which were HK$657 million lower than those for 2005, were needed to cover the formation of new impaired loans[#] and further deterioration of existing impaired accounts.

Net release of collective impairment allowances declined substantially by HK$1,259 million. The reduction reflected a natural slowdown in the improvement in the bad debt migration rate after the Group's significant improvement in asset quality last year on the back of improved economic conditions and borrowers' debt servicing capability.

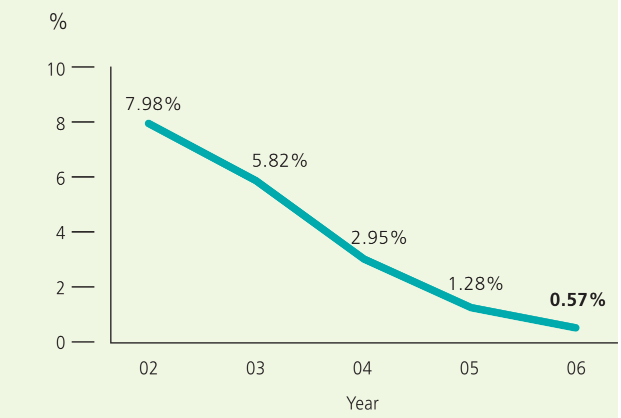
The Group made remarkable progress in the recovery of loans that were previously written off. Total recoveries (individually and collectively assessed) were HK$2,115 million, up HK$476 million, mainly due to the recoveries of certain large accounts.

Second Half Performance

Compared to the first half of 2006, net release of loan impairment allowances was up by HK$506 million in the second half. It was mainly attributable to the recoveries of certain large accounts, which were partially offset by lower release of collective impairment allowances in the second half of the year.

[#] Impaired loans are advances where objective evidence exists that full repayment of principal or interest is considered unlikely.

Classified loan ratio



With low classified loan formation and strong collection efforts, classified loans* were reduced by HK$2,275 million, or 53.4%, in 2006. Classified loan ratio fell from 1.28% in 2005 to a record low of 0.57% at end-2006. At the same time, impaired loan ratio improved from 0.56% to 0.26% at end-2006.

Over the past five years, the Group has shown substantial improvement in asset quality. Classified loans were reduced at a compound annual rate of 47%. Classified loan ratio dropped substantially from 7.98% at end-2002 to 0.57% at end-2006.

* Classified loans represent advances which have been classified as "substandard", "doubtful" and "loss" under the Group's classification of loan quality.

Property Revaluation

HK$'m	**2006**	2005
Net (loss)/gain on revaluation of premises	**(1)**	63
Net gain on fair value adjustments on investment properties	**574**	1,386
Deferred tax	**(55)**	(339)
Net gain on fair value adjustments on investment properties, after tax	**519**	1,047

The aggregate impact of property revaluation before tax on the income statement was HK$573 million, of which HK$574 million came from the revaluation of investment properties and HK$1 million from loss on revaluation of bank premises. The related deferred tax charge on revaluation of investment properties amounted to HK$55 million. As a result, the net impact of fair value adjustments on investment properties on the Group's attributable profit in 2006 was HK$519 million. When compared to 2005, the decrease in net gain on property revaluation was in line with the stabilising property prices.

Second Half Performance

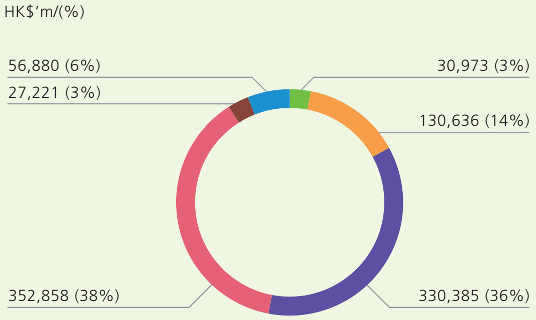
Compared to the first half of 2006, net gain from revaluation of investment properties fell by HK$391 million in the second half, which was in line with the movement of local property prices.

Financial Position

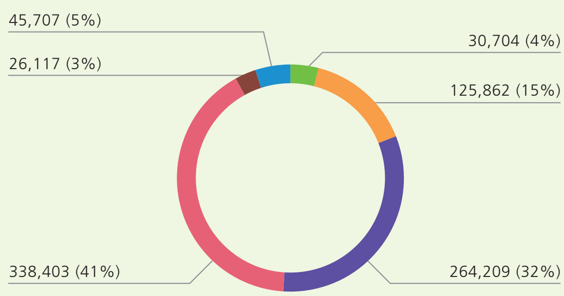
HK$'m, except percentage amounts	**At 31 December 2006**	Restated At 31 December 2005
Cash and balances with banks and other financial institutions	**30,973**	30,704
Placements with banks and other financial institutions	**130,636**	125,862
Hong Kong SAR Government certificates of indebtedness	**34,750**	32,630
Securities investments*	**330,385**	264,209
Advances and other accounts	**352,858**	338,403
Fixed assets and investment properties	**27,221**	26,117
Other assets **	**22,130**	13,077
Total assets	**928,953**	831,002
Hong Kong SAR currency notes in circulation	**34,750**	32,630
Deposits and balances of banks and other financial institutions	**49,034**	40,655
Deposits from customers	**694,691**	632,658
Certificates of deposit issued	**2,498**	3,965
Insurance contract liabilities	**14,239**	7,968
Other accounts and provisions	**47,101**	31,413
Total liabilities	**842,313**	749,289
Minority interests	**1,985**	1,778
Capital and reserves attributable to the equity holders of the Company	**84,655**	79,935
Total liabilities and equity	**928,953**	831,002
Loan-to-deposit ratio	**49.32%**	52.27%

* Securities investments comprise investment in securities, trading securities and other financial instruments at fair value through profit or loss.
** Investments in associates and derivative financial instruments are included in other assets.

Balance Sheet Mix as at 31 December 2006



Balance Sheet Mix as at 31 December 2005



Cash and balances with banks and other financial institutions
Placements with banks and other financial institutions
Securities investments
Advances and other accounts
Fixed assets & investment properties
Other assets

The Group's total assets were HK$928,953 million as at 31 December 2006, up HK$97,951 million or 11.8% from the end of 2005:

- Cash and balances with banks and other financial institutions increased by HK$269 million or 0.9%, while interbank placements increased by HK$4,774 million or 3.8%.
- Securities investments rose by HK$66,176 million, or 25.0%, to HK$330,385 million as the Group increased its investments in asset-backed securities, mortgage-backed securities and selected corporate bonds in order to increase income contribution from securities investments.
- The Group continued to actively manage the balance sheet. As a result, the proportion of short-term surplus funds to total assets decreased while the proportion of securities investment portfolio increased.

Advances to Customers

HK$'m, except percentage amounts	**At 31 December 2006**	**%**	At 31 December 2005	%
Loans for use in Hong Kong	**274,290**	**79.0**	274,002	82.0
Industrial, commercial and financial	**148,780**	**42.9**	146,100	43.7
Individual	**125,510**	**36.1**	127,902	38.3
Trade finance	**16,865**	**4.9**	16,079	4.8
Loans for use outside Hong Kong	**55,935**	**16.1**	43,942	13.2
Total advances to customers	**347,090**	**100.0**	334,023	100.0

Total advances to customers grew by HK$13,067 million or 3.9%, which was mainly attributable to the growth in loans for use outside Hong Kong and corporate loans in Hong Kong. The growth was partly offset by the decline in residential mortgage loan as a result of intensified competition and market sluggishness.

Loans for use in Hong Kong increased slightly by 0.1%:

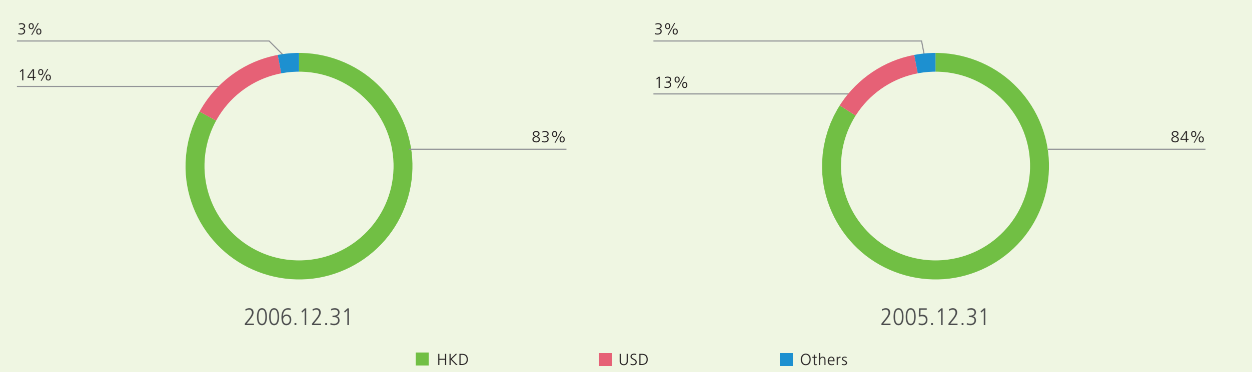
- Lending to the industrial, commercial and financial sectors rose by HK$2,680 million, or 1.8%, driven by loans for property investment and transport and transport equipment.
- Residential mortgage loans (excluding those under GHOS) decreased by HK$2,218 million, or 2.2%, to HK$96,953 million due to keen market competition particularly in the first half of the year.
- Card advances grew by HK$822 million, or 17.6%, to HK$5,490 million as a result of an increase in cardholder spending.
- Other consumer lending rose by HK$751 million, or 9.3%, to HK$8,831 million.

Trade finance increased by HK$786 million, or 4.9%, on the back of robust merchandise exports and strong local demand. Meanwhile, loans for use outside Hong Kong grew significantly by HK$11,993 million or 27.3%. The increase was mainly driven by overseas lending and loan growth of the Group's Mainland branches.

Second Half Performance

When compared to the first half of the year, total loans recorded a broad-based rebound in the second half. Strong growth momentum was shown in both individual and corporate loans. The Group's new pricing strategy on mortgage products was well received. Residential mortgages increased by HK$2,511 million, or 2.7%, recovering much of the fall in the first half of the year. Corporate loans in Hong Kong increased by HK$1,536 million, or 1.0%, while trade finance rose by HK$1,057 million, or 6.7%. Loan for use outside Hong Kong grew significantly by HK$8,047 million, or 16.8%, of which lending through the Group's Mainland branches surged by HK$3,430 million or 22.6%.

Total advances to customers by currency mix (%)



In terms of currency mix, HKD and USD advances to customers accounted for 82.5% and 14.1% respectively at the end of 2006. Other currency advances to customers accounted for 3.4%. There was no significant change in currency mix in 2006.

Deposits from Customers

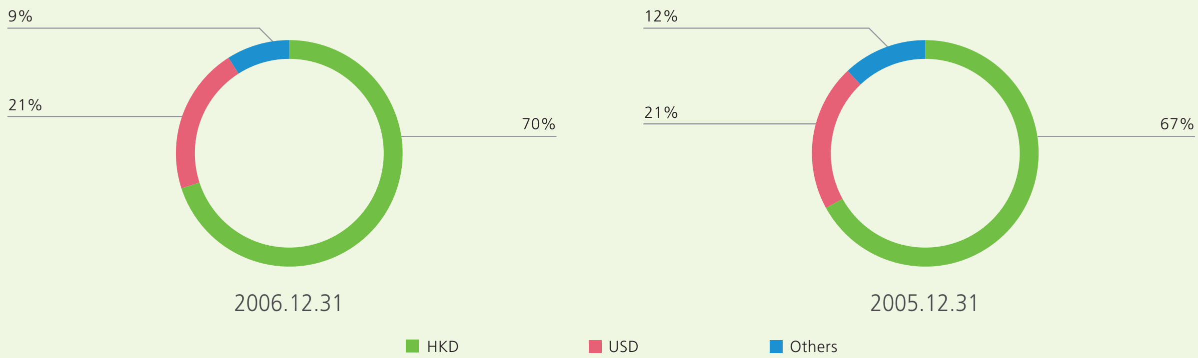
HK$'m, except percentage amounts	At 31 December 2006	%	At 31 December 2005	%
Demand deposits and current accounts	**30,979**	**4.4**	28,948	4.5
Savings deposits	**256,653**	**36.5**	216,540	33.9
Time, call and notice deposits	**407,059**	**57.8**	387,170	60.6
Total deposits from customers	**694,691**	**98.7**	632,658	99.0
Structured deposits	**9,085**	**1.3**	6,373	1.0
Adjusted total deposits from customers	**703,776**	**100.0**	639,031	100.0

Total deposits from customers increased by HK$62,033 million, or 9.8%, to HK$694,691 million in 2006. Given the buoyant stock market, customers were more inclined to maintain a higher degree of liquidity. As a result, savings deposits increased considerably by 18.5% or HK$40,113 million. Time, call and notice deposits rose by 5.1% or HK$19,889 million while demand deposits and current accounts increased by 7.0% or HK$2,031 million. The Group's deposits mix improved with the proportion of lower cost deposits, which consists of current accounts and savings deposits, to total deposits rising from 38.4% at end-2005 to 40.9% at end-2006. There was a growing demand for structured deposits - a hybrid of retail deposit and derivatives offering a higher nominal interest rate to depositors. Structured deposits grew to HK$9,085 million, up HK$2,712 million or 42.6%, representing about 1.3% of the adjusted total deposits from customers. The Group's loan-to-deposit ratio was 49.32% at end-2006.

Second Half Performance

Compared to end-June 2006, total deposits from customers rose by HK$53,800 million, or 8.4%, in the second half. Savings deposits increased by HK$32,685 million, or 14.6%. Time, call and notice deposits grew by HK$18,571 million, or 4.8% while demand deposits and current accounts increased by HK$2,544 million or 8.9%.

Adjusted total deposits from customers by currency mix (%)



In terms of currency mix, HKD and USD deposits accounted for 69.8% and 20.9% respectively at the end of 2006. Other currency deposits accounted for 9.3%. The Group's HKD loan-to-deposit ratio was 58.3%, down from 65.0% at end-2005, mainly due to a higher increase in HKD deposits from customers relative to HKD advances to customers.

Asset Quality

HK$'m, except percentage amounts	**At 31 December 2006**	At 31 December 2005
Advances to customers	**347,090**	334,023
Classified loan ratio[&]	**0.57%**	1.28%
Impairment allowances	**1,103**	1,714
Regulatory reserve for general banking risks	**3,621**	3,526
Total allowances and regulatory reserve	**4,724**	5,240
Total allowances as a percentage of advances to customers	**0.32%**	0.51%
Total allowances and regulatory reserve as a percentage of advances to customers	**1.36%**	1.57%
Impairment allowances on classified loan ratio[##]	**28.62%**	29.77%
Total coverage (including collateral values)[##]	**106.74%**	99.88%
Residential mortgage loans* – delinquency and rescheduled loan ratio**	**0.21%**	0.30%
Card advances – delinquency ratio**[#]	**0.25%**	0.32%

	2006	2005
Card advances – charge-off ratio[#]	**2.44%**	2.67%

& Classified loans represent advances which have been classified as "substandard", "doubtful" and "loss" under the Group's classification of loan quality. Repossessed assets are initially recognised at the lower of their fair value or the amortised cost of the related outstanding loans on the date of repossession. The related loans and advances are deducted from loans and advances.

* Residential mortgage loans exclude those under the Home Ownership Scheme and other government-sponsored home purchasing schemes.

** Delinquency ratio is measured by a ratio of total amount of overdue loans (more than three months) to total outstanding loans.

\# Excluding Great Wall cards and computed according to the HKMA's definition.

\## Only including impairment allowances on loans classified as "substandard", "doubtful" and "loss" under the Group's classification of loan quality.

Movement of Classified Advances to Customers

In HK$ bln	**2006**	2005
Beginning balance	**4.3**	9.2
New classified loans	**0.9**	1.7
Upgraded classified loans	**(0.3)**	(1.2)
Collection	**(2.0)**	(3.8)
Write-off	**(0.8)**	(1.1)
Others	**(0.1)**	(0.5)
Ending balance	**2.0**	4.3

Owing to better credit quality as well as strong collection and write-off, the Group's asset quality continued to improve with the classified loan ratio falling to the historical low of 0.57%, versus 1.28% at end-2005. Classified loans decreased by approximately HK$2.3 billion or 53% to HK$2.0 billion. New classified loans were maintained at a low level, representing less than 0.3% of total loans outstanding. Total collections amounted to approximately HK$2.0 billion. Write-off of classified loans amounted to HK$0.8 billion. About HK$0.1 billion of the reduction in classified loans was due to the treatment of repossessed assets as a direct offset against the classified loans outstanding.

Total impairment allowances, including both IA and CA, amounted to HK$1,103 million. Impairment allowances on classified loan ratio was 28.62%. If the value of underlying collateral was included, the total coverage ratio would increase to 106.74%. The Group's regulatory reserve rose by HK$95 million to HK$3,621 million as advances to customers increased.

The quality of the Group's residential mortgage loans continued to improve. The combined delinquency and rescheduled loan ratio decreased from 0.30% at end-2005 to 0.21% at end-2006. The quality of card advances also improved, with the charge-off ratio dropping from 2.67% to 2.44% year-on-year.

Capital and Liquidity Ratios

HK$'m, except percentage amounts	**At 31 December 2006**	At 31 December 2005
Tier 1 capital	**68,458**	64,213
Tier 2 capital	**4,060**	3,991
Unconsolidated investment and other deductions	**(971)**	(1,004)
Total capital base after deductions	**71,547**	67,200
Risk-weighted assets		
On-balance sheet	**479,082**	412,851
Off-balance sheet	**39,968**	30,713
Deductions	**(7,741)**	(6,450)
Total risk-weighted assets	**511,309**	437,114
Total risk-weighted assets adjusted for market risk	**513,707**	438,213
Capital adequacy ratios (banking group level)		
Before adjusting for market risk		
Tier 1	**13.39%**	14.69%
Total	**13.99%**	15.37%
After Adjusting for market risk		
Tier 1*	**13.33%**	14.65%
Total*	**13.93%**	15.33%

	Full-year ended 31 December 2006	Full-year ended 31 December 2005
Average liquidity ratio	**50.46%**	42.02%

* Capital adequacy ratios take into account market risks and are calculated in accordance with the relevant HKMA guidelines.

Total capital base of the Group after deduction increased by 6.5% to HK$71,547 million, implying an increase in retained earnings. Despite this, the consolidated capital adequacy ratio of the banking group fell to 13.99% from 15.37% at end-2005 because of a 17.0% increase in total risk-weighted assets. This was the result of the growth of securities investment.

Average liquidity ratio rose to 50.46%, compared to 42.02% in 2005. The Group continued to actively manage its balance sheet. Investments in liquefiable securities was increased, which helped strengthen its liquidity position.

BUSINESS REVIEW

This section covers the review of the Group's business lines together with their respective financial results.

RETAIL BANKING

HK$'m, except percentage amounts	**Full-year ended 31 December 2006**	Full-year ended 31 December 2005	Increase/ (decrease)
Net interest income	**7,851**	7,326	+7.2%
Other operating income	**3,534**	2,632	+34.3%
Operating income	**11,385**	9,958	+14.3%
Operating expenses	**(5,033)**	(4,514)	+11.5%
Operating profit before loan impairment allowances	**6,352**	5,444	+16.7%
Net release of/(charge for) loan impairment allowances	**(27)**	956	N/A
Others	**(18)**	(12)	+50.0%
Profit before taxation	**6,307**	6,388	-1.3%

	At 31 December 2006	At 31 December 2005	Increase/ (decrease)
Segment assets	**169,595**	158,844	+6.8%
Segment liabilities	**578,249**	554,244	+4.3%

Note: For additional segmental information, see Note 51 to the Financial Statements.

Results

Retail Banking registered healthy business growth in 2006. Operating income grew by 14.3% year-on-year to HK$11,385 million. The growth was driven by the increase of both net interest income and other operating income. Operating profit before loan impairment allowances increased by HK$908 million or 16.7% to HK$6,352 million. Profit before taxation was HK$6,307 million, down HK$81 million or 1.3% from 2005 because of the relatively high release of impairment allowances recorded in 2005.

Net interest income rose by 7.2% to HK$7,851 million. The overall profitability of Prime-based loans, which formed the bulk of Retail Banking's loan assets, improved due to widened Prime-HIBOR spread. The improvement in loan spread was held back by narrowed deposit spread as increase in savings rates outpaced the increase in market rates.

Other operating income soared by 34.3% to HK$3,534 million because of the strong growth of net fees and commission income by 38.8%. The buoyant equity market and IPO activities spurred the growth of the transaction volume of the Group's stock brokerage business, thereby increasing the commissions from securities trading. This, coupled with the growth of commissions from the sales of open-end investment funds, more than offset the decline in commissions from the sales of structured notes.

Operating expenses rose by 11.5% to HK$5,033 million mainly because of the rise in staff costs after pay rise and the recruitment of new staff to support business expansion.

Retail Banking's net charge for loan impairment allowances for 2006 amounted to HK$27 million, versus net releases of HK$956 million in 2005. The net charge for loan impairment allowances reflected a slowdown in the improvement in bad debt migration and additional allowances for increased credit card advances.

Advances and other accounts, including mortgage loans and card advances, increased by 0.7% to HK$130,124 million. Customer deposits increased by 3.0% to HK$549,982 million.

Strong growth of investment and insurance business

Investment and insurance, both being the Group's business focuses, delivered encouraging results in 2006. Capitalising on bullish stock trading and its enhanced trading platform, the Group grew its stock brokerage business volume substantially by 112%. At the same time, with improved sales productivity and a broadened product range, the Group recorded a 90.0% growth in the sales volume of open-end funds. The China and Emerging Market Equity Funds were some of the best-sellers.

Taking advantage of the IPO boom, the Group launched eIPO financing services while aggressively promoting its IPO-related business. The Group became the major receiving bank for most of the large-scale IPOs in Hong Kong. The number of IPO subscriptions received and processed by the Group reached a record high in 2006. Over 50% of the subscriptions were submitted through the automated channel.

Through effective marketing campaigns and personalised services, the Group grew its number of wealth management customers and assets under management by 45.9% and 42.9% respectively.

To expand its life insurance business, the Group launched a diverse range of new products in 2006, including the "Supreme Saver 06- 5 Year Life Endowment Plan", "Prudent Saver 5-year Life Endowment Plan", "Companion Insurance Plan" and "Total Value Retirement Solution Plan". These products were well received by customers. "Total Value Retirement Solution Plan" was the first kind of investment-linked annuities in the banking market.

Growth momentum of residential mortgages regained

Intense competition and a relatively lacklustre residential mortgage sector had an adverse impact on the Group's residential mortgages in the first half of the year. The Group adjusted its promotion strategies and introduced flexible mortgage products such as "Fixed rate mortgage plan", "HIBOR-based mortgage plan", "All-you-want" and "Smart" mortgage schemes to satisfy customers' diverse finance needs. New residential mortgages grew substantially by 97% in the second half of the year and the Group regained its leading position in the market. Meanwhile, the credit quality of residential mortgages continued to improve as the delinquency and rescheduled loan ratio dropped further to 0.21%.

In pursuit of high net worth customers through professional premium services

The Group continued with its effort to win and better serve high net worth customers in 2006. In collaboration with BOC, in December 2005 the Group launched a new service enabling wealth management customers to access priority and privileged banking services at BOC branches in the whole Asia Pacific region. In addition, value-added banking solutions covering investment management, financial planning and pre-arranged banking services were tailored for Mainland customers. During the year, the BOCHK Wealth Management Expo was held and various large scale and localised investment seminars were organised regularly to update customers on the latest investment climate.

"Wealth MaxiWiser", a financial planning tool, was further enhanced to strengthen portfolio management advisory services, achieve effective customer management and maximise customers' wealth. Currently, 100 Wealth Management Prime centres and 20 Wealth Management VIP centres are in operation to provide tailor-made financial solutions to customers.

Expansion of credit card business

The Group's card business continued to expand in terms of customer base and service range. Card advances increased by 17.6% and the number of cards issued grew by 4.1%. Cardholder spending volume and merchant acquiring volume expanded by 13.7% and 22.5% respectively.

The Group launched "VISA BOC Olympic Games Card" in 2006. With a strong competitive edge in the credit card market, the Group continued to extend appealing merchant offer programmes to customers through a comprehensive merchant network covering Hong Kong, Macau and the Mainland. In the area of merchant acquiring, the Group launched the Dynamic Currency Conversion Service to support real-time currency conversion value-added services to both merchants and credit cardholders.

The Group was the first EMV certificate acquirer in Hong Kong, and had the widest coverage of EMV standard chip-enabled terminals in the local market at end-2006.

The Group's performance and service quality in credit card business were recognised by the industry. During the year, the Group won a total of 22 awards from MasterCard International, Visa International, China UnionPay, Hong Kong Trade Development Council ("HKTDC") and International Licensing Industry Merchandisers' Association ("LIMA") respectively.

Leading Hong Kong's RMB banking business

The Group continued to be the local market leader in Renminbi ("RMB") banking business with a comprehensive range of relevant services. By end-2006, RMB deposits increased by 1.8% from a year ago. The Group also maintained its leading position in the RMB credit card issuing and merchant acquiring business. RMB merchant acquiring volume and RMB card cardholder spending volume registered strong growths of 91.9% and 46.9% respectively. The number of RMB credit cards issued grew by 22.7%. During the year, the Group upgraded the features of its RMB card. Customers can choose their own account withdrawal limit for security purpose and make use of the RMB POS functions in the Mainland to suit their diverse financial needs. At end-2006, the number of ATMs providing RMB withdrawal service reached 230.

In March 2006, the Group launched Renminbi Settlement System ("RSS") to provide clearing services for expanded RMB business in Hong Kong. RSS serves as a quality clearing platform and provides a solid foundation for the further expansion of RMB business. At the same time, Personal RMB Cheque Service was launched to enable customers to make payment in Guangdong Province by cheque.

Branch rationalisation and e-Channel Development

The Group continued to optimise its branch network in 2006. During the year, the Group opened 3 new branches, renovated 54 existing branches and revamped 14 wealth management centres. By the end of 2006, the number of branches in Hong Kong was 287 and the number of ATM machines was 445.

To offer more convenient and reliable e-service to customers, the Group upgraded its internet banking services. Apart from enhanced investment functions and new e-banking products, the Group's website was revamped to strengthen online sales and promotion. Over the year, the number of e-banking customers and transactions increased by 15.2% and 62.6% respectively.

CORPORATE BANKING

HK$'m, except percentage amounts	**Full-year ended 31 December 2006**	Full-year ended 31 December 2005	Increase/ (decrease)
Net interest income	**4,281**	3,776	+13.4%
Other operating income	**1,209**	1,113	+8.6%
Operating income	**5,490**	4,889	+12.3%
Operating expenses	**(1,500)**	(1,293)	+16.0%
Operating profit before loan impairment allowances	**3,990**	3,596	+11.0%
Net release of loan impairment allowances	**1,817**	1,689	+7.6%
Others	**(3)**	(1)	+200.0%
Profit before taxation	**5,804**	5,284	+9.8%

	At 31 December 2006	At 31 December 2005	Increase/ (decrease)
Segment assets	**222,701**	211,834	+5.1%
Segment liabilities	**148,353**	101,719	+45.8%

Note: For additional segmental information, see Note 51 to the Financial Statements.

Results

Corporate Banking reported a profit before taxation of HK$5,804 million in 2006, up HK$520 million or 9.8% as compared to 2005. Operating profit before loan impairment allowances increased by 11.0% to HK$3,990 million. Net interest income and other operating income grew by 13.4% and 8.6% respectively, while the release of loan impairment allowances grew by 7.6%.

The rise in net interest income was driven by the widened loan spread and deposit spread while the growth of other operating income was due to increased net fees and commission income from loans and remittance. Operating expenses were up 16.0% to HK$1,500 million on account of the rise in staff costs.

Net loan impairment releases were HK$1,817 million, up 7.6%, mainly due to recoveries of certain large accounts.

Advances and other accounts increased by 6.5% to HK$221,552 million. Customer deposits registered a robust growth of 46.6% to HK$145,781 million.

Leading in loan syndication

The Group maintained its leading position in the syndication loan market covering Hong Kong, Macau and the Mainland. According to *Basis Point*, a leading Asian capital market magazine, the Group was the number one mandated arranger in the Mainland-Hong Kong-Macau syndicated loan market in 2006.

Phenomenal growth of IPO financing

Riding on the active stock market, the Group expanded its IPO financing business significantly. It provided more than HK$200 billion worth of financing to corporate and retail customers in connection with the IPO of 28 companies in Hong Kong. The Group's IPO financing business in 2006 recorded a tenfold growth versus 2005.

Expanding SME lending and customer base

In 2006, the Group focused on adjusting its business and customer structures and devoted much effort in developing its SME business. The Group's 5-year SME business plan focuses on the enhancement of the SME business model, optimising credit approval procedures for SME loans, streamlining the existing workflow, and raising the efficiency of customer service. These growth initiatives were beginning to bear fruit as evidenced by the double-digit growth in SME loans. To better serve these customers, the Group successfully launched and refined several products, including Equipment Link, Professional Firms Link, and Trade Peak Season Link.

Reinforcing cash management business and e-banking platform

With a view to growing its cash management business, the Group actively reinforced its service platform and coverage, its connection with BOC's overseas branches, and the service plans for large corporations. At the same time, *BOC Wealth Master*, a standardised cash management product, was launched to better serve SME customers by providing a one-stop, multi-channel and multi-account platform for them to do their financial management more efficiently. During the year, a Cash Management Services Centre was established to enhance the Group's competitiveness in the cash management business.

The Group continued to strengthen its e-banking functions and promote CBS Online services. The number of CBS Online customers increased significantly. By end-2006, the number of CBS Online customers increased by 98% from a year ago.

Growing and strengthening trade finance business

To achieve greater flexibility and to optimise credit limit utilisation, the Group refined the trade finance credit limit structure and simplified the procedure for arranging and using trade finance credit limits. The Group also launched several new trade finance products and promotion plans, including Pre-shipment Financing, Bill Service and Trade Finance Promotion Scheme. As a result of these initiatives, bills and settlement volume increased by 16.5% in 2006.

Optimising business model

In 2006, the Group refined its business model, organisation structure, management process and business workflow for Corporate Banking to align with the Relationship-Product-Channel ("RPC") Model. For instance, steps were taken to review and enhance the business authorisation system, implement the *Two-step Credit Approval Scheme*, and simplify the credit renewal and review procedures. The Group also implemented the *Enhanced Relationship Manager Mechanism* and *Product Manager Mechanism* to strengthen the relationship and product professional teams. Under this refined business model, the Group is in a better position to manage its customer relations and product development by taking into consideration individual clients' industry, geographical location and sectoral characteristics and developing tailor-made products to suit their specific needs.

Growing Mainland business steadily

The Group's Mainland branches regained its growth momentum and delivered strong results in 2006, notwithstanding a relatively slow first half. Profit before loan impairment allowances increased by HK$64 million, or 20.6% due mainly to the increase in advances to customers. Total advances to customers rose by 22.7% to HK$18.6 billion. Customer deposits increased by 67.4% to HK$3.9 billion. Asset quality continued to improve with the classified loan ratio falling by 0.34 percentage point to 0.23%.

The business scope of the Group's Mainland branches and sub-branches expanded further during the year. By the end of 2006, the Group had a total of 11 Mainland branches and sub-branches permitted to participate in RMB business. The Qingdao branch submitted its application for running RMB business. All the 14 branches and sub-branches are now licensed to conduct derivatives business and provide insurance agency services. The coverage of the Group's wealth management products was extended to the Mainland in 2006. In view of the high demand for investment products, the Group launched commodity-linked deposits in 2006 as an extension of the currency-linked deposits offered since 2005. After the approval by China Banking Regulatory Commission to conduct QDII business in October, the Group applied for the RMB exchange limit of foreign exchange trade with State Administration of Foreign Exchange. In November, following the announcement by the Commission of the new Regulations on Administration of Foreign-funded Banks, the Group resolved to incorporate the local operation of the Group's wholly-owned subsidiary, Nanyang Commercial Bank, in the Mainland to offer comprehensive banking services with the focus on retail banking whereas BOCHK would maintain its foreign-funded bank status to concentrate on corporate and foreign exchange businesses.

TREASURY

HK$'m, except percentage amounts	**Full-year ended 31 December 2006**	Full-year ended 31 December 2005	Increase/ (decrease)
Net interest income	**4,286**	2,428	+76.5%
Other operating income	**743**	1,021	-27.2%
Operating income	**5,029**	3,449	+45.8%
Operating expenses	**(458)**	(308)	+48.7%
Operating profit	**4,571**	3,141	+45.5%
Others	**(2)**	–	N/A
Profit before taxation	**4,569**	3,141	+45.5%

	At 31 December 2006	At 31 December 2005	Increase/ (decrease)
Segment assets	**497,155**	426,791	+16.5%
Segment liabilities	**98,531**	82,381	+19.6%

Note: For additional segmental information, see Note 51 to the Financial Statements.

Results

In 2006, Treasury reported remarkable growth in profit before taxation by HK$1,428 million, or 45.5%, as net interest income rose sharply. Other operating income decreased by HK$278 million or 27.2%. Operating expenses increased by HK$150 million or 48.7% to HK$458 million.

Net interest income increased substantially by HK$1,858 million or 76.5%. The increase was mainly driven by higher contribution of net free fund due to the rise in market rates and better return on debt securities portfolio as a result of the Group's effective balance sheet management.

Other operating income decreased by HK$278 million or 27.2%, resulting from a reduction of net trading income of foreign exchange swap contracts for funding purpose.

Enhancing yield by diversifying investment portfolio and vastly expanding IPO business

In 2006, Treasury's structure and portfolio management strategy were refined to focus more on balance sheet management and structural risk management. In order to improve return, three specialised portfolio management teams on interest rate, credit and securitised products were set up respectively to provide professional analysis and information on different markets and products. During the year, the Group actively managed its investment portfolio by diversifying into mortgage-backed securities, covered bonds and corporate bonds to maximise the return on residual funds. This diversification also helped create a more balanced portfolio and reduce concentration risks. As a result of these initiatives, investment return exceeded the Group's target despite the flattening yield curve. Moreover, as a receiving bank for 23 IPOs in Hong Kong in 2006, the Group handled a total amount of IPO funds of over HK$1,000 billion – a record high.

Enhancing product offerings and marketing in Hong Kong and Mainland

In 2006, market volatility in interest rates, foreign exchange, and commodity and equity trading meant more opportunities for the development of treasury products. In view of the growing popularity of structured investment products, the Group introduced a series of structured deposits linked with interest rates, foreign exchange rates and bullion prices. During the year, the Group launched a large number of structured deposits in Hong Kong and the Mainland respectively. To further enhance cross-selling activities with retail and corporate customers, a special treasury marketing unit providing customised services to local and Mainland customers was set up in late 2005. The team also provided training and consulting support to other marketing teams. This not only enhanced the marketing capability of different business units for treasury products, but also helped broaden the Group's treasury client base. In 2006, the number of treasury customers increased by 42.3%.

INSURANCE

HK$'m, except percentage amounts	**Full-year ended 31 December 2006**	Full-year ended 31 December 2005	Increase/ (decrease)
Net interest income	**473**	318	+48.7%
Other operating income	**6,421**	3,230	+98.8%
Operating income	**6,894**	3,548	+94.3%
Net insurance benefits and claims	**(6,655)**	(3,362)	+97.9%
Net operating income	**239**	186	+28.5%
Operating expenses	**(65)**	(56)	+16.1%
Operating profit	**174**	130	+33.8%
Others	**–**	12	N/A
Profit before taxation	**174**	142	+22.5%

	At 31 December 2006	At 31 December 2005	Increase/ (decrease)
Segment assets	**15,804**	9,343	+69.2%
Segment liabilities	**14,649**	8,365	+75.1%

Note: For additional segmental information, see Note 51 to the Financial Statements.

Results

The Group's Insurance segment recorded a profit before taxation of HK$174 million, up HK$32 million or 22.5% as compared to 2005. This was mainly driven by an increase in net interest income.

Net interest income rose by 48.7% to HK$473 million. This was mainly attributable to an increase in the investments of debt securities on the back of significant growth of premium income arising from the successful launch of several new insurance products. Other operating income rose by 98.8% to HK$6,421 million with the growth of premium income and an increase in the fair value of interest rate instruments and structured notes. In line with the growth of premium income, net insurance benefits and claims increased by 97.9% to HK$6,655 million.

Assets in the Insurance segment grew by 69.2% because of the increase in investments of interest rate instruments and structured notes. Liabilities rose by 75.1%, which was mainly the result of increased insurance contract liabilities.

Successful acquisition of controlling stake in BOC Life

The Group acquired from its parent the BOC Group a 51% controlling stake in BOC Life in June 2006. Life insurance policies, investment products linked with life insurance policies and retirement scheme management plans are offered through the Group's extensive distribution network. This will help the Group to enhance its wealth management platform, solidify its client base and increase its non-interest income.

Broadening product range and stepping up sales training

Following the combination with BOC Life, the Group started offering a more diversified range of insurance products to meet customers' needs. In 2006, a series of new insurance products were introduced and customers' response was very encouraging. Premium from new business increased by 77% in 2006. To equip frontline staff with deeper professional knowledge and better sales techniques, the Group established an in-house academy, the BOCG Life Bancassurance Academy, to provide systematic professional training to the Group's sales staff. Such training would focus on selling long-term insurance products. By end-2006, more than 110 of the Group's employees had participated in the training.

Building up BOC Life as a brand

To strengthen BOC Life's branding in Hong Kong, the Group organised a series of large-scale promotional activities under the theme "BOC(HK) Insurance, We Care More". A series of promotional campaigns were also launched to support this branding exercise.

IMPLEMENTATION OF RELATIONSHIP-PRODUCT-CHANNEL ("RPC") MODEL

The Group strongly believes that a customer-centric management and business model is crucial for sustaining business and profit growth, thus maximising shareholder return. In accordance with the Group's 2006-2011 Strategic Plan, the Group started implementing in early 2007 the RPC (Relationship, Product and Channel Management) Model. As reported in 2006, the objectives of the model are to build teams of dedicated and professional managers to develop and expand the range of products and services that are tailored to the needs of different customer segments, and to optimise channels and workflow to facilitate sales and marketing. Under this Model, the Group will reinforce its capabilities in customer relationship management (R), product management (P), as well as channel management (C). To ensure success, the Group established a Steering Committee and Implementation Task Force to formulate an implementation plan, and to monitor and provide guidance in the implementation process. Besides, five dedicated groups with representatives from different business units responsible for job evaluation and staff placements, premises assignment, communication, training and finance have been set up to organise, execute and closely monitor progress.

CORPORATE DEVELOPMENT, TECHNOLOGY AND OPERATIONS

Human resources

During the year, the Group continued to invest in human resources development to support business growth and help realise its corporate vision of becoming customers' premier bank. Medium-term initiatives were taken to enhance staff commitment, improve productivity and optimise the allocation of resources. In addition, relevant strategies and action plans to support the implementation of the RPC Model were developed and rolled out.

An employee performance management system was introduced in 2006. It emphasises ongoing evaluation of staff performance throughout the year and the formulation of staff training and development plans. This system is meant to enhance the Group's overall performance and help develop a performance-driven corporate culture.

In 2006, more than 1,500 training courses with over 91,000 attendants were organised. Such courses included workshops and seminars on wealth management, financial planning, risk management, corporate governance and corporate culture. Other training channels were also made available to the staff. For instance, an e-learning platform was set up to provide online interactive training; a self-learning programme integrating distance learning was offered; and small group tutorials and tests were launched. Moreover, to support the Group's long-term business expansion, a one-year Officer Trainees Programme was introduced to provide on-the-job training for newly recruited university graduates. A three-year intensive and systematic programme tailor-made for Management Trainees recruited from local and overseas universities also commenced in 2006.

Technology and operations

To support business growth and the RPC model, the Group continued to enhance its information technology infrastructure and implement its 5-year IT development strategy. The processing capacity of the Securities Management System was significantly expanded to cater for the increased volume of stock transactions. The Group's eIPO services that came on stream in March 2006 also helped capture business opportunities arising from the booming stock market. In October 2006, an eIPO service which enables customers to subscribe IPO shares using white forms online was successfully launched. The Group's internet banking functions, such as stock and futures trading services, foreign exchange margin trading and accounts management, were also enhanced. Meanwhile, new web pages were introduced to provide more financial and non-financial information. The Customer Relationship Management System ("CRM"), which provides an integrated view of customers, was established in 2006 to help frontlines perform better customer analysis and segmentation, as well as facilitate the formulation of marketing strategies.

As part of the Group's IT strategy, the Group kick-started the implementation of the Financial and Financial Risk Management System ("FRMS") in 2006. It is a project aiming to revamp the existing computer systems for different finance functions, including financial accounting, management accounting, multi-dimension profitability management, and capital management. It will also help enhance the Group's asset & liability management ("ALM"). The project is being rolled out in phases. During the year, the Group started the roadmap and general ledger design and implementation of ALM system. It is expected that the system will help increase automation, improve operational efficiency and provide value-added information and analytics for management decisions.

To streamline operating workflows and enhance work efficiency, in January 2006, the Business Optimisation Centre was established to expedite business operations reform and take charge of project management, such as the implementation of RPC model, develop optimal project plans and initiates and undertakes business process re-engineering.

REGULATORY DEVELOPMENT

Basel II Capital Accord

Following the release of the new international capital adequacy framework, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (known as "Basel II"), by Basel Committee on Banking Supervision in June 2004, Hong Kong was among the first batch of major international financial centres to introduce Basel II in January 2007. The new capital adequacy framework, which comprises three Pillars, is more risk sensitive than the 1988 Accord. Pillar One aligns regulatory capital requirements more closely with inherent risks and introduces new capital charge on operational risk. Pillar Two stipulates a framework for the supervisory review of capital adequacy by the regulatory authority while Pillar Three requires a greater scope of disclosure on capital adequacy and risk management.

The Group has deployed substantial resources to the implementation of Basel II with significant progress. The adoption of Basel II has had the full support of the senior management. Chaired by the Chief Executive, a steering committee, Basel II Implementation Steering Committee, was established to enhance and monitor Basel II implementation. Reporting to the Chief Risk Officer, the Basel II Implementation Office was set up to co-ordinate and ensure proper implementation.

In relation to Pillar One, all the preparatory works, including system and reporting enhancements, have been completed and the Group will adopt the Standardised Approach to calculate the minimum capital requirement on credit risk, market risk and operational risk. It also undertook parallel runs with prevailing capital requirements on the calculation of capital adequacy ratio.

Under Pillar Two, Authorised Institutions are encouraged to develop their systems for conducting the capital adequacy assessment process ("CAAP"). The Group is currently in the process of planning for Pillar Two implementation. Pillar Three, which is expected to be fully implemented by June 2007, focuses on the disclosure requirements and policies prescribed by the Banking (Disclosure) Rules. The Group expects that substantial investment will be required to fully implement Basel II and considers that continuous monitoring of the process and policies is important. The Group also believes that the new framework will further strengthen its risk management and facilitate its capital planning and management practices.

CREDIT RATINGS

As at 31 December 2006	Long-term	Short-term
Fitch	A	F1
Moody's	A2	P-1
Standard & Poor's	BBB+ (Upgraded to 'A-' on 16 February 2007)	A-2

During the year, the credit ratings of BOCHK were revised by the leading rating agencies.

On 19 June 2006, Fitch Ratings upgraded the individual rating of BOCHK to B from B/C. As at 31 December 2006, BOCHK's long-term and short-term foreign currency issuer default ratings were A and F1 respectively while the support rating was 2.

On 7 July 2006, Moody's Investors Service upgraded its rating outlook on BOCHK from stable to positive and on 11 August 2006, the financial strength rating was under Moody's review for possible upgrade. As at 31 December 2006, BOCHK's long-term and short-term foreign currency bank deposit ratings as assigned by Moody's were A2 and P-1 respectively.

As at 31 December 2006, the long-term and short-term counterparty credit ratings assigned by Standard & Poor's to BOCHK were BBB+ and A-2 respectively. On 16 February 2007, Standard & Poor's raised the long-term counterparty credit rating to A- and affirmed A-2 short-term counterparty credit rating on BOCHK.

PROGRESS UPDATE OF 2006-2011 STRATEGIC PLAN

In March 2006, the Group announced its 2006-2011 Strategic Plan which would guide it in developing into a top-quality financial services group with a powerful base in Hong Kong, a solid presence in China, and a strategic foothold in Asia. During the year, the Group made good progress in achieving the key strategic focuses. The table below encapsulates the major progress achieved by the Group in 2006.

• Strengthening the Group's Leading Position in Hong Kong	The Group maintained its leading position in the Mainland-Hong Kong-Macau syndication loan market, local residential mortgage business, personal RMB business, RMB merchant acquiring business and RMB card issuing business respectively. In ROE lucrative segments, the Group made good progress in the following areas: – **Wealth Management:** The number of total wealth management customers increased by 45.9% and assets under management rose by 42.9%. Investment and insurance fee income surged by 62.5%, of which fee income from stockbroking and sales of funds rose significantly by 93.7% and 56.2% respectively. – **Consumer Lending:** Credit card advances and other consumer lending increased by 17.6% and 9.3% respectively. – **Cash Management:** A cash management team was set up to enhance the Group's cash management platform by enabling it to offer more related services and products to customers. – **SMEs:** The Group achieved double-digit growth in SME loans. The management of the SME segment has been shaped up to drive business growth. The Group's relationship management team has been proactively expanding the number of SME clients. – **RMB Banking Services:** The Group remained the market leader in Hong Kong's personal RMB banking business and was authorised by the People's Bank of China to continue serving as the RMB Clearing Bank in Hong Kong. It launched the RMB Settlement System ("RSS") together with the RMB Cheque Clearing Services during the year. In connection with the impending issuance of yuan-denominated bonds in Hong Kong, the role of BOCHK as RMB clearing bank could be expanded to cover yuan bonds as well.
• Developing New Capabilities in Product Manufacturing/ Distribution	– The Group proactively sought out and carefully examined a number of M&A opportunities in Hong Kong. – The Group acquired 51% controlling stake in BOC Life, leading to substantial growth in insurance and investment income, profit and assets. – The Group's insurance product portfolio also expanded significantly. In 2006, a series of new products were introduced and were well received by customers. – The Group embarked on aggressively building up its sales strengths in insurance. It established an in-house insurance academy aiming at providing systematic training for sales staff selling long-term insurance products. In 2006, more than 110 employees were trained by this academy.
• Building a Stronger Presence in China	– Total advances to customers and customer deposits of the Group's Mainland branches increased by 22.7% and 67.4% respectively in 2006. – The Group submitted its application for the local incorporation of Nanyang Commercial Bank, its wholly-owned subsidiary, in the Mainland to offer comprehensive banking services with the focus on retail banking.
• Seeking Regional Expansion	The Group has been actively seeking out M&A opportunities in the region, with a view to identifying really suitable potential targets.

• Corporate Values and Core Competencies	**Corporate Values** – During the year, the Group introduced an employee performance management system which emphasises on-going coaching and staff performance evaluation. In addition, as a commitment to long-term human resources development, the Group launched training programmes for Officer Trainees and Management Trainees respectively. – In September, the Group started implementing the five-day work week to enable the staff to have more time for leisure and personal pursuits, and to enjoy better quality of life. – The Group demonstrated its commitment to corporate social responsibility by participating actively in various social welfare and voluntary services. For details of its involvement in social responsibility, please refer to pages 82 to 84 – Good Corporate Citizenship. **Core Competencies** The Group received public recognition for its achievements in several key aspects during the year, ranging from corporate governance and disclosure to marketing and banking services. (For details, please refer to relevant sections.)

RISK MANAGEMENT

Banking Group

Overview

The Group believes that sound risk management is crucial to the success of any organisation. In its daily operation, the Group attaches a high degree of importance to risk management and emphasises that a balance must be struck between risk control and business growth and development. The principal types of risk inherent in the Group's businesses are reputation risk, legal and compliance risk, strategic risk, credit risk, market risk, interest rate risk, liquidity risk and operational risk. The Group's risk management objective is to enhance shareholder value by maintaining risk exposures within acceptable limits.

Risk Management Governance Structure

The Group's risk management governance structure is designed to cover the whole process of all businesses and ensure various risks are properly managed and controlled in the course of conducting business. The Group has a sound risk management organisational structure. It implements a comprehensive set of policies and procedures to identify, measure, monitor and control various risks that may arise. These risk management policies and procedures are regularly reviewed and modified to reflect changes in markets and business strategies. Various groups of risk takers assume their respective responsibilities for risk management.

The Board of Directors, representing the interests of shareholders, is the highest decision making authority of the Group and has the ultimate responsibility for risk management. The Board, with the assistance of its committees, has the primary responsibility for the formulation of risk management strategies and for ensuring that the Group has an effective risk management system to implement these strategies. The Risk Committee ("RC"), a standing committee established by the Board of Directors, is responsible for overseeing the Group's various types of risks, reviewing and approving high-level risk-related policies and overseeing their implementation, reviewing significant or high risk exposures or transactions and exercising its power of veto if it considers that any transaction should not proceed. The Audit Committee assists the Board in fulfilling its role in overseeing the internal control system.

The Chief Executive's ("CE") is responsible for managing the Group's various types of risks, approving detailed risk management policies, and approving material risk exposures or transactions within his authority delegated by the Board of Directors. The Chief Risk Officer ("CRO") assists the CE in fulfilling his responsibilities for the day-to-day management of risks. The CRO is responsible for initiating new risk management strategies, projects and measures that will enable the Group to better monitor and manage new risk issues or areas that may arise from time to time from new businesses, products and changes in the operating environment. He may also take appropriate initiatives in response to regulatory changes. The CRO is also responsible for reviewing material risk exposures or transactions within his delegated authority and exercising his power of veto if he believes that any transaction should not proceed.

Various departments of the Group have their respective risk management responsibilities. Business units act as the first line of defense while risk management units, which are independent from the business units, are responsible for the day-to-day management of different kinds of risks. Risk management units have the primary responsibilities for drafting, reviewing and updating various risk management policies and procedures.

The Group's principal banking subsidiaries, Nanyang and Chiyu, are subject to risk policies that are consistent with those of the Group. These subsidiaries execute their risk management strategies independently and report to the Group's management on a regular basis.

Reputation Risk Management

Reputation risk is the risk that negative publicity regarding the Group's business practices, whether genuine or not, might cause a potential decline in the Group's customer base or lead to costly litigation or revenue erosion. Reputation risk is inherent in every aspect of business operation and covers a wide spectrum of issues.

In order to mitigate reputation risk, the Group has formulated its Reputation Risk Management Policy that is diligently implemented. This policy provides guidance to prevent and manage reputation risk proactively at an early stage. It requires constant monitoring of external reputation risk incidents and published failures of risk incidents in the financial industry.

Legal and Compliance Risk Management

Legal risk is the risk that unenforceable contracts, lawsuits or adverse judgments may disrupt or otherwise negatively affect the operation or financial condition of the Group. Compliance risk is the risk of penalty arising from any failure to comply with relevant regulations governing the conduct of businesses in specific countries. By establishing and maintaining appropriate policies and guidelines, the CRO, working through the Legal and Compliance Department, is responsible for proactively identifying and managing these risks.

Strategic Risk Management

Strategic risk generally refers to the risks that may induce immediate or future negative impact on the financial and market positions of the Group because of poor strategic decisions, improper implementation of strategies and lack of response to the market. The Group has developed a Strategic Risk Management Policy that provides clear guidance for the management and oversight of such risks.

Credit Risk Management

Credit risk is the risk that a customer or counterparty will be unable to or unwilling to meet a commitment it has entered into with the Group. The Risk Management Department ("RMD"), under the supervision of the CRO, provides centralised management of credit risk within the Group. Different credit approval and control procedures are adopted according to the level of risk associated with the customer or transaction. Corporate credit applications are independently reviewed and objectively assessed by risk management units. A credit scoring system is used to process retail credit transactions, including residential mortgage loans, personal loans and credit cards. The Credit Risk Assessment Committee comprising experts from credit and other functions of the Group is responsible for making an independent assessment of all credit facilities which require the approval of Deputy Chief Executives or above.

The Group adopts an eight-grade facility grading structure according to HKMA's loan classification requirement. RMD provides regular credit management information reports and ad hoc reports to the Management Committee, RC, AC and Board of Directors.

Market Risk Management

Market risk is the risk of loss that results from movements in market rates and prices. The Group's market risk arises from customer-related business and proprietary trading. Trading positions are subject to daily marked-to-market valuation. Market risk is managed within the risk limits approved by RC. The overall risk limits are divided into sub-limits by reference to different risk factors, including interest rate, foreign exchange rate, commodity price and equity price.

RMD is responsible for the oversight of the Group's market risk to ensure that overall and individual market risks are within the Group's risk tolerance. Risk exposures are monitored on a day-to-day basis to ensure that they are within established risk limits.

VAR is a statistical technique which estimates the potential losses that could occur on risk positions taken over a specified time horizon within a given level of confidence. The Group uses historical movements in market rates and prices, a 99% confidence level and a 1-day holding period to calculate portfolio and individual VAR.

The following table sets out the VAR for all trading market risk exposure of BOCHK.

HK$'m		At 31 December	Minimum during the year	Maximum during the year	Average for the year
VAR for all market risk	– 2006	1.5	1.3	5.0	2.8
	– 2005	1.8	1.2	5.8	2.6
VAR for foreign exchange risk	– 2006	1.7	0.7	5.3	2.8
	– 2005	1.2	0.6	5.2	1.9
VAR for interest rate risk	– 2006	0.7	0.7	3.0	1.6
	– 2005	1.4	0.9	3.7	2.1
VAR for equity risk	– 2006	0.5	0.1	1.0	0.3
	– 2005	0.1	0.0	0.5	0.1

For the year ended 31 December 2006, the average daily revenue of BOCHK earned from market risk-related trading activities was HK$2.5 million (2005: HK$2.0 million). The standard deviation of these daily trading revenues was HK$1.5 million (2005: HK$1.8 million).

Interest Rate Risk Management

The Group's interest rate risk exposures are mainly structural. The major types of interest rate risk from structural positions are:

repricing risk – mismatches in the maturity or repricing periods of assets and liabilities

basis risk – different pricing basis for different transactions so that yield on assets and cost of liabilities may change by different amounts within the same repricing period

The Group's Asset and Liability Management Committee ("ALCO") maintains oversight of interest rate risk and RC sanctions the interest rate risk management policies formulated by ALCO. The interest rate risk is identified and measured on a daily basis. The Treasury Department manages the interest rate risk according to the established policies. The Finance Department closely monitors the related risks and the results are reported to RC and ALCO regularly.

Gap analysis is one of the tools used to measure the Group's exposure to repricing risk. This provides the Group with a static view of the maturity and repricing characteristics of its balance sheet positions. The Group uses interest rate derivatives to hedge its interest rate exposures and in most cases, plain vanilla interest rate swaps are used.

Sensitivities of earnings and economic value to interest rate changes (Earnings at Risk and Economic Value at Risk) are assessed through a hypothetical interest rate shock of 200 basis points across the yield curve on both sides. Earnings at Risk and Economic Value at Risk are controlled respectively within an approved percentage of the projected net interest income for the year and the latest capital base as sanctioned by RC. The results are reported to ALCO and RC on a regular basis.

The impact of basis risk is gauged by the projected change in net interest income under scenarios of imperfect correlation in the adjustment of the rates earned and paid on different instruments. Ratios of assets to liabilities with similar pricing basis are established to monitor such risk.

Liquidity Risk Management

The aim of liquidity management is to enable the Group to meet, even under adverse market conditions, all its maturing repayment obligations on time, and to fund all its asset growth and strategic opportunities without forced liquidation of its assets at short notice.

The Group funds its operations principally by accepting deposits from retail and corporate depositors. In addition, the Group may issue certificates of deposit to secure long-term funds. Funding may also be secured through adjusting the asset mix in the Group's investment portfolio. The Group uses the majority of funds raised to extend loans, to purchase debt securities or to conduct interbank placements.

The Group monitors the liquidity risks using cash flow analysis and by examining deposit stability, concentration risk, mismatch ratios, loan-to-deposit ratio and liquidity profile of the investment portfolio. The primary objective of the Group's asset and liability management strategy is to achieve optimal returns while ensuring adequate levels of liquidity and capital within an effective risk control framework and ALCO is responsible for establishing these policy directives (including the liquidity contingency plan), and RC sanctions the liquidity management policies. The Treasury Department manages the liquidity risk according to the established policies. The Finance Department monitors the Group's liquidity risks and reports to the management and ALCO regularly.

Operational Risk Management

Operational risk relates to the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. RMD oversees the entire operational risk management framework of BOCHK.

The Group has put in place an effective internal control process which requires the establishment of detailed policies and control procedures for all the key activities. Proper segregation of duties and independent authorisation are the fundamental principles followed by the Group. The management of respective business lines is responsible for managing and reporting operational risks specific to their business units by identifying, assessing and controlling the risks inherent in their business processes, activities and products. These are followed by periodic monitoring and ongoing review of changes by RMD. RMD formulates corporate-level policies and procedures concerning operational risk management which are approved by RC. RMD evaluates the operational risk profile, records operational risk data and reports operational risk issues to RC and senior management.

Business continuity plans are in place to support business operations in the event of emergency or disaster. Adequate backup facilities are maintained and periodic drills are conducted. The Group also arranges insurance cover to reduce potential losses in respect of operational risk.

Capital Management

The major objective of capital management is to maximise total shareholders' return while maintaining a capital adequacy position in relation to the Group's overall risk profile. The Group periodically reviews its capital structure and adjusts the capital mix where appropriate to achieve the lowest overall cost of capital. ALCO monitors the Group's capital adequacy. The Group has complied with all the statutory capital standards for all the periods presented in the report.

Stress Testing

The Group supplements the analysis of various types of risks with stress testing. Stress testing is a risk management tool for estimating the Group's risk exposures under stressed conditions arising from extreme but plausible market or macroeconomic movements. These tests are conducted on a regular basis and ALCO monitors the results against limits approved by RC. Stress test results are also reported to the Board and RC regularly.

Insurance Group

The principal activity of the Group's insurance business is the underwriting of long-term insurance business in life and annuity, linked long-term business and retirement scheme management in Hong Kong. Major types of risks inherent in the Group's insurance business include insurance risk, interest rate risk and credit risk. BOC Life manages these risks independently and reports to the Group's management on a regular basis. The key risks of its insurance business and related risk control process are as follows:

Insurance Risk Management

BOC Life is in the business of insuring against the risk of mortality, morbidity, disability, critical illness, accidents and related risks. BOC Life manages these risks through the application of its underwriting policies and reinsurance arrangement.

The underwriting strategy is intended to set premium pricing at an appropriate level that corresponds with the underlying exposure of the risks underwritten. Screening processes, such as the review of health condition and family medical history, are also included in BOC Life's underwriting procedures.

Within the insurance process, concentrations of risk may arise where a particular event or series of events could impact heavily upon BOC Life's liabilities. Such concentrations may arise from a single insurance contract or through a small number of related contracts, and relate to circumstances where significant liabilities could arise.

For the in-force insurance contracts, most of the underlying insurance liabilities are related to endowment and unit-linked insurance products. For most of the insurance policies issued by it, BOC Life has a retention limit of HK$400,000 on any single life insured. BOC Life reinsures the excess of the insured benefit over HK$400,000 for standard risks (from a medical point of view) under an excess of loss reinsurance arrangement. BOC Life does not have in place any reinsurance for contracts that insure survival risk.

Uncertainty in the estimation of future benefit payments and premium receipts for long-term insurance contracts arises from the unpredictability of long-term changes in overall levels of mortality. In order to assess the uncertainty due to the mortality assumption and lapse assumption, BOC Life conducts mortality study and lapse study in order to determine the appropriate assumptions. In these studies, consistent results are reflected in both assumptions with appropriate margins.

Interest Rate Risk Management

The main risk that BOC Life faces due to the nature of its investment and liabilities is interest rate risk. BOC Life manages these positions within an asset liability management ("ALM") framework that has been developed to achieve long-term investment returns in excess of its obligations under insurance contracts. For each distinct category of liabilities, a separate portfolio of assets is maintained. The principal technique of ALM is to match assets to the liabilities arising from insurance contracts by reference to the type of benefits payable to contracts holders.

Credit Risk Management

BOC Life has exposure to credit risk, which is the risk that a counterparty will be unable to pay amounts in full when due. Key areas where BOC Life's insurance business is exposed to credit risk are:

– counterparty risk with respect to structured products transactions and debt securities
– reinsurers' share of insurance unpaid liabilities
– amounts due from re-insurers in respect of claims already paid
– amount due from insurance contract holders
– amount due from insurance intermediaries

BOC Life structures the levels of credit risk it accepts by placing limits on its exposure to a single investment counterparty, or groups of counterparties. Such risks are subject to an annual or more frequent review. Limits on the level of credit risk by category are reviewed and approved regularly by the management.