Raymond Or
Vice-Chairman and Chief Executive

CHIEF EXECUTIVE'S REPORT

Hang Seng's results for 2008 reflect the difficult operating environment, particularly in the second half of the year.

Our well-considered strategy, trusted brand and prudent approach to business helped cushion the impact of the global financial tsunami. We strengthened our balance sheet through early action to manage credit risk in customer lending and Treasury's balance sheet management portfolio, and significantly reduced equity risk through disposal of our equity portfolios. We maintained good cost control while investing in the long-term development of our business. We achieved income growth across three of our four core customer groups but profitability was affected by increased loan impairment charges and other credit risk provisions.

Personal Financial Services maintained good earnings for the first half of 2008, but recorded a 29.4 per cent decline in profit before tax to HK$8,410 million for the year, with unfavourable investor sentiment leading to significant reductions in fee and trading income during the second half. Operating profit excluding loan impairment charges was down 30.2 per cent at HK$8,467 million.

Supported by our diverse portfolio of products and time-to-market strength, we retained our competitive edge in wealth management, with particular progress in insurance business. Wealth management revenue increased in the first half of the year, but with the sharp downturn in financial markets in the second half growth slowed, resulting in a 37.6 per cent fall in income for the year.

Net interest income remained stable, with the success of our credit card portfolio and the careful expansion of our personal loans portfolio offsetting narrowing margins on deposits and mortgage lending. We increased our market share for credit card business in terms of the card base, spending and receivables.

Commercial Banking achieved more diversified revenue streams, with year-on-year increases in every major income category. Operating profit excluding loan impairment charges rose by 6.5 per cent to HK$2,354 million. However, increased loan impairment provisions in the unfavourable economic environment saw profit before tax fall by 8.6 per cent to HK$2,470 million.

Leveraging our large base of business customers, we selectively grew average customer advances by 14.5 per cent.

Falling commodity prices and the slowdown in international trade led to a year-on-year decline in trade finance, while factoring advances rose. The reduction in interest rates dragged down deposit spreads, offsetting in part the 14.7 per cent increase in net interest income from advances to give an overall net interest income growth of 2 per cent.

Commercial Banking's other operating income rose by 11.8 per cent. We increased revenue from corporate wealth management by 4.5 per cent, contributing 10.4 per cent of total operating income. We improved corporate life insurance product offerings and sales training, leading to a 96.6 per cent rise in revenue.

The successful launch of express China remittance services underpinned an encouraging improvement in our outward remittance market share. Our comprehensive financial solutions for retailers helped us capture more card merchant-acquiring business, with good growth in related fee income. Our card merchant services were a continuing source of new customer acquisitions. We achieved a 5.5 per cent year-on-year increase in the number of new commercial customers.

Corporate Banking's operating profit excluding loan impairment charges rose by 36.3 per cent to HK$815 million. Profit before tax grew by 35.8 per cent to HK$645 million. We attained a 37.4 per cent increase in net interest income, with increases in average customer advances and deposits of 7.9 per cent and 5.4 per cent respectively. Having exercised restraint in asset growth leading up to 2008, Corporate Banking was able to support customers with new or renewed facilities at good risk-adjusted returns. Net interest income from advances was up 45.3 per cent.

Treasury recorded a 98 per cent rise in operating profit excluding credit risk provisions to HK$3,037 million. Operating profit increased by 8.3 per cent to HK$1,662 million.

The balance sheet management portfolio benefited from favourable interest rate movements, with net interest income increasing by 104.4 per cent to HK$2,682 million. Beginning in late 2007 as signs of the global financial crisis began to emerge, we took steps to reduce the credit risk of the balance sheet management portfolio. Throughout 2008, we enhanced the credit quality of the debt securities portfolio through the active disposal of some negotiable instruments. During the last quarter of 2008, we made selective investments in high-quality debt securities, most of which were triple-A rated papers. However, the growing credit crunch and deteriorating economic conditions in the second half had a negative impact on some balance sheet management portfolio investments. With reduced investor appetite for equities, we expanded trading income by successfully promoting foreign exchange-linked products and capital protected investments.

Profit before tax, including share of profits from associates, increased by 24.6 per cent to HK$2,279 million.

Further efforts to expand the capabilities and reach of our Mainland business supported significant growth in the customer and deposit bases. Our investment in Industrial Bank continued to yield good returns.

Our Mainland subsidiary bank, Hang Seng Bank (China) Limited, extended its network to 33 outlets across 11 cities. Full-time equivalent staff increased by 32.2 per cent to 1,450. Enhanced customer relationship management helped drive the development of our wealth management business.

Hang Seng China's total operating income rose by 63.7 per cent, but further investment in new outlets and staff, exchange losses on US dollar capital funds upon revaluation against the renminbi and an increase in loan impairment charges led to a drop in profit before tax.

Including our share of profit from Industrial Bank, Mainland business contributed 11.9 per cent of total profit before tax, compared with 6.5 per cent a year earlier.

In the last quarter of 2008, we completed an RMB800 million acquisition of 20 per cent of the enlarged share capital of Yantai City Commercial Bank – one of the largest city commercial banks in Shandong province. This investment has strengthened our foothold in the Mainland's rapidly developing Bohai Economic Rim region and complements our existing operations which are concentrated in the Pearl River Delta and Yangtze River Delta regions.

Following the success of our brand rejuvenation programme in 2006-07, we made more investments in brand building in 2008 to strengthen our image as a professional wealth management partner, increasing our appeal among key customer segments.

FINANCIAL HIGHLIGHTS

Attributable profit for 2008 was down 22.7 per cent at HK$14,099 million, due mainly to the drop in wealth management income and increase in loan impairment charges and other credit risk provisions in the second half of the year. In 2007, we recorded a dilution gain on our investment in Industrial Bank. Excluding this gain, attributable profit was down 16 per cent.

Our strong brand and wide range of products and services helped support revenue streams. Net operating income before loan impairment charges and other credit risk provisions grew by 15.1 per cent during the first half, but with the sustained decline in market conditions during the second half, was down HK$1,719 million, or 6.9 per cent, at HK$23,296 million for the year.

Operating profit excluding loan impairment charges and other credit risk provisions fell by 10.1 per cent to HK$16,501 million, with solid growth in net interest income more than offset by reduced non-interest revenue, particularly from fee-generating business. The 381.9 per cent increase in loan impairment charges and other credit risk provisions to HK$2,776 million saw operating profit fall by 22.8 per cent to HK$13,725 million.

Profit before tax was HK$15,878 million – a drop of 26 per cent compared with a year earlier, or 20.6 per cent excluding the 2007 dilution gain.

Net interest income increased by 10.3 per cent to HK$16,232 million, underpinned by the 11.6 per cent rise in average customer advances, growth of lending at improved pricing and higher margins on Treasury's balance sheet management portfolio. The 6.8 per cent rise in average customer deposits was outweighed by narrower deposit spreads. Net interest margin was up 13 basis points at 2.36 per cent. Net interest spread rose by 31 basis points to 2.15 per cent, benefiting from asset repricing, better Treasury portfolio yields and growth in low-cost customer deposits.

Net fee income fell by 27.8 per cent to HK$4,969 million, due mainly to a significant drop in investment services-related income. The success of our credit card merchant-acquiring business helped drive growth of 24.4 per cent in card services revenue and we achieved solid increases in income from remittances and credit facilities. Our comprehensive wealth management offerings helped maintain investment-related growth during the first six months of the year, but with the sharp drop in investor activity during the second half, revenues from stockbroking and related services, retail investment funds and structured investment products were all down compared with 2007.

The unfavourable investment environment also affected trading income from securities, derivatives and other trading activity. With reduced customer interest in equities investments, our timely promotion of foreign-exchange linked products drove encouraging growth in related revenue. Overall, trading income fell by 13.3 per cent to HK$1,455 million.

Wealth management income was up 2.2 per cent at HK$3,518 million for the first half of 2008, but down 37.6 per cent at HK$5,389 million for the year.

As economic conditions became more uncertain, our diverse wealth management portfolio and time-to-market advantage helped us rapidly shift our sales focus to more defensive products. However, the significant drop in investment activity saw investment income decline by 40.8 per cent to HK$3,692 million. Private banking income was down 75.4 per cent.

Enhancements to retirement planning and protection products led to good growth of HK$2,629 million, or 28 per cent, in net earned insurance premiums. We were Hong Kong's number one life insurance provider in terms of new annualised regular premiums for the first three quarters of 2008 and increased our market share.

We took early steps to defend the life insurance funds portfolio against the market downturn. In the second quarter, we replaced a substantial proportion of equities investments under the portfolio with debt securities investments, resulting in a 47.5 per cent year-on-year rise in net interest income and a significantly reduced loss on investment returns of HK$35 million during the second half compared with the HK$1,030 million loss in the first six months of the year. Overall, insurance income was down 29.4 per cent at HK$1,697 million, due mainly to the HK$1,065 million loss on investment returns.

Our strong brand and
wide range of products and services
helped support revenue streams

Operating expenses increased by HK$145 million, or 2.2 per cent, reflecting investment in future business growth on the Mainland. Excluding our Mainland business, operating costs fell by 2.7 per cent, with traditional cost discipline and lower performance-related pay expenses outweighing rising salary and rental costs.

At the beginning of 2008, we switched from the 'standardised approach' to the 'foundation internal ratings-based approach' for calculating capital ratios under Basel II. As at 31 December 2008, our capital adequacy ratio and core capital ratio were 12.5 per cent and 9.5 per cent respectively.

We continue to command high credit ratings. Our B+ financial strength rating and B+ fundamental strength rating from Moody's Investors Service and Standard & Poor's respectively are the highest such ratings for Hong Kong banks. Hang Seng China has been assigned local and foreign currency long-term counterparty credit ratings of A+ and local and foreign currency short-term counterparty credit ratings of A-1 by Standard & Poor's, and long-term domestic and foreign currency deposit ratings of A1 and short-term domestic and foreign currency deposit ratings of Prime-1 by Moody's.

As at 31 December 2008, shareholders' funds (excluding proposed dividends) were HK$45,890 million, a 9.5 per cent decline compared with a year earlier, due largely to the fair-value changes in available-for-sale investments.

Total assets grew by 2.2 per cent to HK$762.2 billion. At year-end, the advances-to-deposits ratio was 54.4 per cent, compared with 52.2 per cent a year earlier.

Gross advances to customers grew by 7 per cent to HK$331.2 billion.

With export activity and commodity prices declining, trade finance fell by 17.2 per cent. Factoring advances increased by 2.8 per cent. We maintained our consistently prudent lending policies in support of corporate and commercial customers.

Lending to individuals (excluding Government Home Ownership Scheme mortgages) rose by 3.6 per cent. Credit card advances were up 13.1 per cent on the back of good increases in the card base and spending. Residential mortgage lending remained competitive, but our e-Mortgage services helped us record growth of 4.4 per cent. We increased our personal loan market share to 8.2 per cent.

Loans for use outside Hong Kong rose by 10.2 per cent to HK$35.8 billion. Mainland lending increased by 3.7 per cent to HK$26.9 billion.

As operating conditions for businesses become increasingly difficult, loan impairment charges rose. As at 31 December 2008, total loan impairment allowances as a percentage of gross advances to customers was 0.61 per cent, compared with 0.34 per cent a year earlier. Gross impaired advances as a percentage of gross advances to customers was up 0.6 percentage points at 1 per cent.

Customer deposits grew by 2.3 per cent to HK$604.5 billion. Time deposits, certificates of deposit and other debt securities in issue all fell, but these drops were outweighed by increased savings account deposits and the 91.8 per cent growth in deposits from Hang Seng China on the back of a rise in the number of accounts and enhanced renminbi services.

BRANDING

In the increasingly difficult operating environment, our well-respected brand helped differentiate us from our peers.

In 2006, we launched an integrated brand rejuvenation programme to further strengthen customer loyalty and increase Hang Seng brand preference among key market segments.

Testimonial-based TV commercials featuring true stories of well-known Hang Seng customers focused on the areas of small and medium-sized enterprise (SME) services, investment, insurance, e-Banking, credit cards, Commercial Banking and Prestige Banking. These commercials received favourable external feedback, especially with regard to our professional and trustworthy image.

The launch of innovative products such as the Hang Seng Islamic China Index Fund and convenient new services including Mobile Trading, e-Priority Booking and Green Banking have enhanced our wealth management image and reinforced our progressive approach to business.

We developed a new branch design with a vibrant green as our new corporate colour. The bulkheads at all branches now reflect the new look, and recently opened and refurbished branches have adopted the design throughout their premises. Along with pop concert and television drama sponsorship, the dynamic image conveyed by the new design has helped us rejuvenate our image and build stronger connections with young people.

Our research shows that these efforts over the past few years have successfully improved our brand preference and recommendation scores, especially among young and affluent customer segments. We are now one of the top two bank brands in Hong Kong, with one-third of retail banking customers naming Hang Seng as their most preferred bank and year-on-year growth of 13 per cent in the number of our retail banking customers willing to recommend us to others. We are also among the top two banks for brand recommendation in the SME segment. Over 40 per cent of our SME customers would recommend us to others, and, beginning in 2006, we have won the SME's Best Partner Award from the Hong Kong Chamber of Small and Medium Business for three consecutive years.

RISING TO THE CHALLENGE

The global financial crisis posed new challenges in 2008 and the year ahead is likely to be equally demanding. The global recession may lead to further deterioration in our operating environment. Hong Kong's economy is expected to continue to contract in 2009.

Our sound financial fundamentals, strong franchise and culture of service excellence are important competitive advantages.

Our trusted brand has also proved a valuable tool in deepening existing customer relationships and establishing new ones. We will continue to leverage our strong reputation and track record to increase our market share in core business areas and key customer segments, including through the launch of more Hang Seng-branded products.

Aided by our diverse portfolio of investment and insurance offerings and time-to-market capability, we will remain proactive in providing tailor-made wealth management solutions in changing economic conditions.

Our Commercial Banking teams in Hong Kong, the Mainland and Macau will continue to work together to offer our business customers the advantage of efficient one-stop financial services. We will further grow our corporate wealth management capabilities.

In the tighter credit environment, we are working to support our SME customers. We have approved over 1,000 applications totalling close to HK$3 billion under the revised SME Loan Guarantee Scheme and Special Loan Guarantee Scheme launched by the Hong Kong government.

Treasury will actively manage its well-diversified portfolio and continue to prudently grow non-interest income by offering customer-driven products and efficient service delivery.

Additional outlet openings and strengthened relationship management will help Hang Seng China expand its customer and deposit bases to provide a springboard for future growth. We will build on the synergies created by our strategic partnerships.

We will continue to capitalise on the good progress made under our brand rejuvenation programme.

This will be my last annual report for Hang Seng as I will retire from my position as Vice-Chairman and Chief Executive following the Bank's AGM on 6 May 2009. It has been both an honour and a pleasure to serve Hang Seng since 2005. I wish to thank my fellow Directors for their support and wise counsel, and my colleagues for their hard work and dedication, which have been central to the good progress we have made in further enhancing Hang Seng's brand strength and market position. I must also convey my heartfelt appreciation to our customers and shareholders for their strong support in these endeavours.

I would like to take this opportunity to wish my successor, Mrs Margaret Leung – currently Group General Manager and Global Co-Head Commercial Banking for the HSBC Group – every success in her new role.

The past year has been a testing one. But it has also reminded us to never underestimate the positive power of prudence and working as a team.

Our customers have come to bank on our sound business judgement and passion for providing premium service. Hang Seng, in turn, continues to benefit from their loyalty and trust.

Hang Seng is committed to working with customers, business partners and local communities to tackle future challenges and capitalise on opportunities for sustainable growth.

Raymond Or
Vice-Chairman and Chief Executive
Hong Kong, 2 March 2009