Management Discussion and Analysis
Financial Review

FINANCIAL PERFORMANCE

Income Statement

Summary of financial performance

Figures in HK$m	**2009**	2008
Total operating income	**32,816**	34,759
Total operating expenses	**6,676**	6,795
Operating profit after loan impairment charges and other credit risk provisions	**13,324**	13,725
Profit before tax	**15,477**	15,878
Profit attributable to shareholders	**13,221**	14,099
Earnings per share (in HK$)	**6.92**	7.37

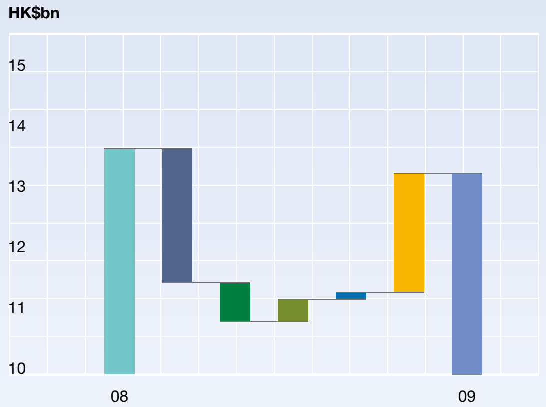
Hang Seng Bank Limited ("the Bank") and its subsidiaries and associates ("the Group") reported an audited profit attributable to shareholders of HK$13,221 million for 2009, down by 6.2 per cent compared with 2008. Earnings per share were HK$6.92, down HK$0.45 from 2008. Attributable profit to shareholders for the second half of 2009 rose by HK$319 million, or 4.9 per cent, when compared with the first half.

Operating profit excluding loan impairment charges and other credit risk provisions fell by HK$2,365 million, or 14.3 per cent, to HK$14,136 million.

Although the economic environment in Hong Kong began to show signs of gradual recovery and market sentiment improved during the second half of the year, operating conditions in 2009 were challenging. The continuing low interest rate environment had a significant adverse impact on net interest income. Non-interest income also fell although there was notable growth in the second half of the year compared with the first half. Operating expenses were contained at a lower level than in 2008.

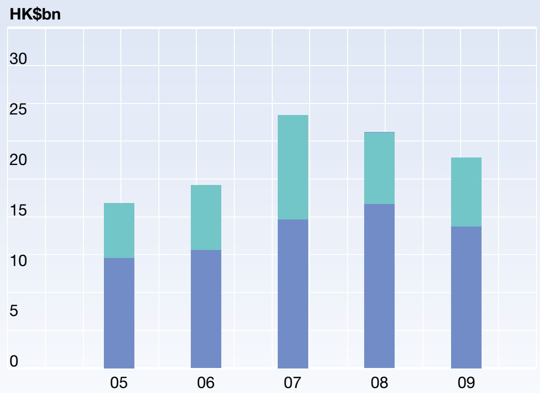
Net interest income fell by HK$2,209 million, or 13.6 per cent, due mainly to the adverse impact of the low interest rate environment.

Operating Profit Analysis



	HK$m
2008 Operating profit	13,725
Changes due to:	
Net interest income	(2,209)
Net fee income	(648)
Other operating income	373
Operating expenses	119
Loan impairment charges and other credit risk provisions	1,964
2009 Operating profit	13,324

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



Figures in HK$m	**2009**	2008
Net interest income/ (expense) arising from:		
– financial assets and liabilities that are not at fair value through profit and loss	**14,151**	17,277
– trading assets and liabilities	**(234)**	(1,211)
– financial instruments designated at fair value	**106**	166
	14,023	16,232
Average interest-earning assets	**736,953**	688,252
Net interest spread	**1.84%**	2.15%
Net interest margin	**1.90%**	2.36%

While average interest-earning assets increased by HK$48.7 billion, or 7.1 per cent, funds were deployed into high quality but low yield liquid assets to reduce risk. Net interest income was also affected by the repricing of assets due to the decline in interest rates.

Net interest margin decreased by 46 basis points to 1.90 per cent compared with 2008. Net interest spread declined by 31 basis points to 1.84 per cent, attributable mainly to compressed deposit margins in the low interest rate environment which offered little room for the reduction of interest rates paid to customers. Treasury balance sheet management income was also affected by the repricing of assets as interest rates fell. Volume growth was noted in the average balance of mortgage lending, offsetting the effect of tighter spreads on mortgages in an intensely competitive market. The increase in the higher-yielding credit card business also helped support net interest income revenue streams. The Group has grown its life insurance business and changed the mix of the assets held in the life insurance funds investment portfolio to held-to-maturity securities, increasing its contribution to interest income by 38.1 per cent compared with 2008.

The contribution from net free funds dropped by 15 basis points to 0.06 per cent as a consequence of the low interest rate environment.

The HSBC Group reports interest income and interest expense arising from financial assets and financial liabilities held for trading as "Net trading income". Income arising from financial instruments designated at fair value through profit and loss is reported as "Net income from financial instruments designated at fair value" (other than for debt securities in issue and subordinated liabilities, together with derivatives managed in conjunction with them).

The table below presents the net interest income of Hang Seng, as included within the HSBC Group accounts:

Figures in HK$m	**2009**	2008
Net interest income	**14,137**	17,233
Average interest-earning assets	**670,321**	664,750
Net interest spread	**2.06%**	2.34%
Net interest margin	**2.11%**	2.59%

Net fee income fell by HK$648 million, or 13.0 per cent, to HK$4,321 million, compared with 2008.

Although the economic environment began to improve in the second half of 2009, investor demand for retail investment funds and structured investment products remained weak, resulting in declines in income of 44.3 per cent and 91.8 per cent respectively. Income from stockbroking and related services registered encouraging growth of 15.2 per cent on the back of the 25.7 per cent increase in stock trading turnover – a significant outperformance of the Hong Kong stock market. Private banking services fee income fell, reflecting reduced customer appetite for trading and structured investment products.

Card services income was 8.4 per cent higher than in 2008 and was broadly in line with the growth in average card balances. The Bank's effective customer loyalty scheme and card utilisation promotions helped drive up Hang Seng card spending in 2009 to outperform the shrinking market. The increase in card income was also supported by year-on-year increases of 6.5 per cent in the number of cards in circulation and 9.1 per cent in cardholder spending.

Insurance fee income rose by 93.9 per cent, mainly contributed by strong sales of the HSBC Jade Global Universal Life product.

Compared with the first half of 2009, net fee income grew by HK$469 million, or 24.4 per cent, in the second half, partly reflecting increased demand for wealth management products coupled with renewed activity in the stock market. Higher income was recorded from retail investment funds with the timely launch of a China Index-linked fund and a global high-yield bond fund. Income from stockbroking and related services benefitted from the rebound in the stock market and increased IPO activity. Income from card services, private banking and trade services also registered solid growth in the second half of 2009 as compared to the first half.

Trading income rose significantly by HK$468 million, or 32.2 per cent, to HK$1,923 million.

Foreign exchange income increased by 29.5 per cent, mainly due to the combined effect of the favourable increase in net interest income from funding swaps* and the reduction in exchange losses on Hang Seng China's US dollar capital funds upon revaluation against the renminbi. Normal foreign exchange trading, however, fell by 14.2 per cent.

Income from securities, derivatives and other trading activities increased by HK$60 million, or 84.5 per cent. This was the net result of the improvement in securities trading activities and the decreased customer appetite for equity-linked structured products.

* Treasury from time to time employs foreign exchange swaps for its funding activities, which in essence involve swapping a currency ("original currency") into another currency ("swap currency") at the spot exchange rate for short-term placement and simultaneously entering into a forward exchange contract to convert the funds back to the original currency on maturity of the placement. In accordance with HKAS 39, the exchange difference of the spot and forward contracts is required to be recognised as foreign exchange gain/loss, while the corresponding interest differential between the original and swap funding is reflected in net interest income.

Financial instruments designated at fair value reported a net loss of HK$75 million, improved by HK$956 million, or 92.7 per cent, when compared with 2008.

This was mainly due to the improved financial markets in 2009 and the switching of the equity component of the investment assets of the life insurance funds investment portfolio for high-quality debt securities in the second half of 2008.

Net earned insurance premiums fell by HK$832 million, or 6.7 per cent. Net insurance claims incurred and movement in policyholders' liabilities rose by HK$541 million, or 4.7 per cent.

Analysis of income from wealth management business

Figures in HK$m	2009	2008
Investment income:		
– retail investment funds	604	1,084
– structured investment products*	473	882
– private banking service fee**	158	248
– stockbroking and related services	1,566	1,359
– margin trading and others	141	119
	2,942	3,692
Insurance income:		
– life insurance	2,070	1,383
– general insurance and others	337	314
	2,407	1,697
Total	5,349	5,389

* Income from structured investment products includes income reported under net fee income on the sales of third-party structured investment products. It also includes profit generated from the selling of structured investment products in issue, reported under trading income.

** Income from private banking includes income reported under net fee income on investment services and profit generated from selling of structured investment products in issue, reported under trading income.

Wealth management business income was broadly in line with 2008, falling by HK$40 million, or 0.7 per cent. The investment climate in 2009 remained weak, although there was an upturn in demand for wealth management products during the second half of the year. To cater for changing customer demands in uncertain financial markets, the Group rapidly shifted its focus to personal insurance protection and lower-risk investment products. This resulted in an encouraging growth of 41.8 per cent in insurance income which partly offset the 20.3 per cent decline in investment income.

Income from retail investment funds and structured products was adversely affected by the unfavourable investment climate and equity markets volatility that took hold in the second half of 2008. However, as economic conditions stabilised during 2009, effective actions to support improving investor sentiment led to a solid increase in investment income in the second half of the year compared with the first half. The Bank capitalised on opportunities to promote yield-enhancing investment products in the context of the low interest rate environment. The launch of the Hang Seng China Index Linked Fund and Hang Seng Global Financial Sector Bond Fund boosted investment funds sales during the second half but this only partly offset the overall decline in demand for investment funds, with investment funds turnover and income 41.0 per cent and 44.3 per cent respectively for the year. Structured investment products income declined by 46.4 per cent.

Income from stockbroking and related services rose by 15.2 per cent on the back of the Bank's efforts to grow its market share to capitalise on the stock market rebound in the second half of 2009. The Bank captured additional sales opportunities by offering professional and convenient trading services to customers via its new Securities Select Customer Trading Centre. These efforts helped increase year-on-year securities turnover by 25.7 per cent.

Private Banking service fee income was lower than in 2008, affected by the weak investment sentiment and lower volume of customer transactions. The Bank expanded its business by strengthening its relationship management team, enhancing investment services support and implementing a variety of wealth management initiatives that will ensure it can take better advantage of medium and long-term business opportunities.

To meet customers' increased focus on wealth preservation in the changing economic conditions, the Group diversified its insurance product range and introduced new plans with improved protection propositions. In the intensely competitive operating environment, the Group recorded an increase in renewal business but new business declined, with net earned life insurance premiums down by 6.9 per cent. With the Bank having shifted the portfolio mix away from equities to debt securities in the second half of 2008, the investment returns improved from an investment loss of HK$1,065 million in 2008 to an investment gain of HK$17 million in 2009. Net interest income and fee income from the life insurance funds investment portfolio rose by 43.7 per cent, contributed by the growth in the life insurance funds investment portfolio and asset reallocation. The increase more than offset the rise in net insurance claims incurred and movement in policyholders' liabilities.

General insurance income increased by 7.3 per cent to HK$337 million.

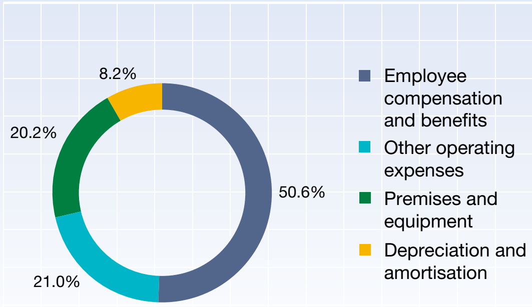
Figures in HK$m	**2009**	2008
Life insurance:		
– net interest income and fee income	**2,012**	1,400
– investment returns on life insurance funds	**17**	(1,065)
– net earned insurance premiums	**11,193**	12,023
– net insurance claims incurred and movement in policyholders' liabilities*	**(11,912)**	(11,357)
– movement in present value of in-force long-term insurance business	**760**	382
	2,070	1,383
General insurance and others	**337**	314
Total	**2,407**	1,697

* Including premium and investment reserves

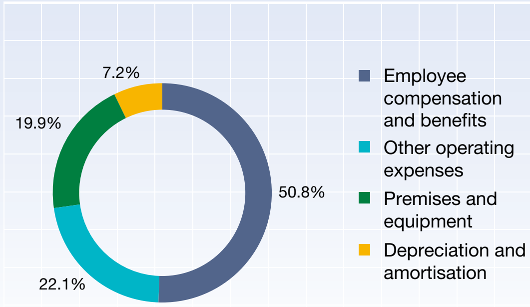
Operating expenses fell by HK$119 million, or 1.8 per cent, to HK$6,676 million.

Operating expenses fell by HK$119 million, or 1.8 per cent, compared with 2008, reflecting lower staff-related expenses and the Bank's well-managed cost control in the difficult operating environment. Excluding Mainland business, operating expenses fell by 2.0 per cent.

Operating Expenses for 2009



Operating Expenses for 2008



Employee compensation and benefits decreased by HK$74 million, or 2.1 per cent. Salaries and other costs decreased by 3.7 per cent, reflecting the decline in average headcount and other staff-related costs. Performance-related pay expenses dropped by 18.4 per cent. Retirement benefit costs increased, due mainly to a reduction in the expected investment return for 2009. General and administrative expenses decreased by 3.6 per cent, with close cost management in marketing and advertising partly offset by rising rental expenses. Depreciation charges rose by 7.9 per cent, reflecting the acquisition of equipment, fixtures and fittings for the Bank's Kowloon Bay office and head office in Central.

Staff numbers* by region

	2009	2008
Hong Kong	**7,834**	8,256
Mainland	**1,449**	1,450
Others	**59**	58
Total	**9,342**	9,764

* Full-time equivalent

At 31 December 2009, the Group's number of full-time equivalent staff was down by 422 compared with the end of 2008 – with the reduction mainly at the Group's Hong Kong operations. The number of staff was closely monitored and headcount in Hong Kong was gradually reduced through natural attrition. Headcount for the Bank's Mainland operations remained stable.

The cost efficiency ratio for 2009 was 32.1 per cent, compared with 29.2 per cent for 2008, with the increase in the ratio due primarily to the reduction in net operating income before impairment charges and other credit risk provisions.

Loan impairment charges and other credit risk provisions improved significantly, falling by HK$1,964 million, or 70.7 per cent, to HK$812 million, with good credit risk management and improving economic conditions in the second half of 2009.

Figures in HK$m	**2009**	2008
Loan impairment charges:		
– individually assessed	**(310)**	(925)
– collectively assessed	**(502)**	(476)
	(812)	(1,401)
of which:		
– new and additional	**(1,104)**	(1,505)
– releases	**230**	48
– recoveries	**62**	56
	(812)	(1,401)
Other credit risk provisions	**–**	(1,375)
Loan impairment charges and other credit risk provisions	**(812)**	(2,776)

With no impairment losses against available-for-sale securities, other credit risk provisions were down significantly when compared with 2008, which saw a HK$1,375 million write down of the carrying value of certain available-for-sale debt securities in the second half of the year.

Individually assessed provisions fell by HK$615 million due mainly to lower new and additional impairment charges and a higher net release on the accounts of certain corporate and commercial banking customers. The mortgage portfolio continued to be well secured with an average loan-to-value ratio below 40 per cent.

Collectively assessed provisions rose slightly by HK$26 million, reflecting a rise in credit card delinquencies against the backdrop of higher card spending and the uncertain economic environment. Impairment provisions for personal loan portfolios also increased modestly.

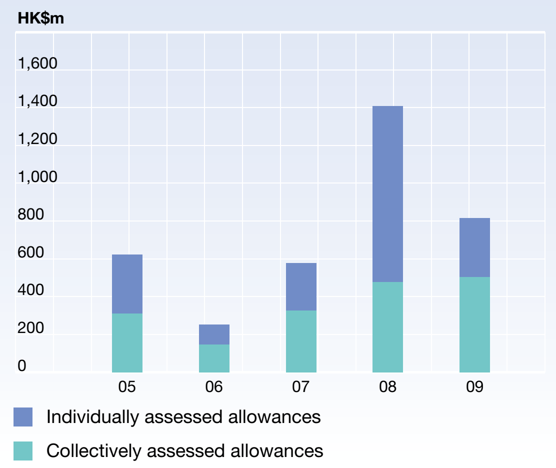
Total loan impairment allowances as a percentage of gross advances to customers are as follows:

	2009	2008
	%	%
Loan impairment allowances:		
– individually assessed	**0.33**	0.37
– collectively assessed	**0.23**	0.24
Total loan impairment allowances	**0.56**	0.61

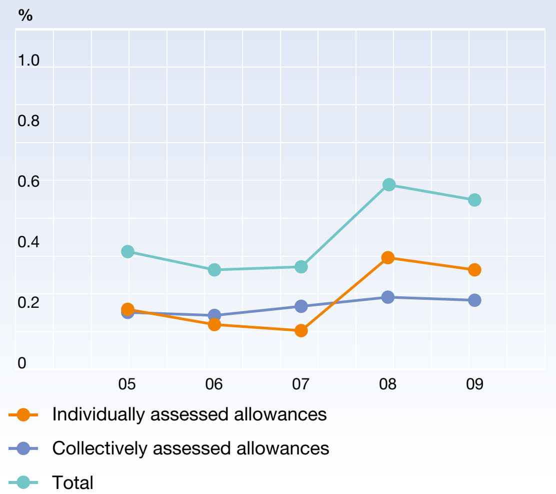
Operating profit was down HK$401 million, or 2.9 per cent, at HK$13,324 million.

Profit before tax fell by 2.5 per cent to HK$15,477 million, after taking into account a HK$140 million increase in **net surplus on property revaluation**; HK$81 million fall in **gains less losses from financial investments and fixed assets** and HK$59 million drop in **share of profits from associates**, mainly from Industrial Bank.

Net Charges for Loan Impairment Allowances



Loan Impairment Allowances as a Percentage of Gross Advances to Customers



Gains less losses from financial investments and fixed assets amounted to HK$186 million, a decrease of 30.3 per cent when compared with 2008.

As the Group disposed of most of its equity holdings in 2008, net gains from the disposal of available-for-sale equity securities decreased by HK$485 million, or 75.1 per cent and impairment charges for certain available-for-sale equity securities amounted to HK$4 million compared with charges of HK$284 million in 2008. The net gain on the disposal of assets held for sale increased by HK$187 million, due mainly to a gain on the disposal of a property.

Net surplus on property revaluation rose by 177.2 per cent to HK$219 million.

Figures in HK$m	**2009**	2008
Surplus of revaluation on investment properties	**250**	8
(Revaluation deficit)/ reversal of revaluation deficit on premises	**(31)**	71
	219	79

The Group's premises and investment properties were revalued at 30 November 2009 and updated for any material changes at 31 December 2009 by DTZ Debenham Tie Leung Limited. The valuation was carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use and the basis of valuation for investment properties was open market value. The net revaluation surplus for Group premises amounted to HK$669 million of which HK$700 million was credited to premises revaluation reserve and HK$31 million was charged to the income statement. Revaluation gains of HK$250 million on investment properties were recognised through the income statement. The related deferred tax provisions for Group premises and investment properties were HK$109 million and HK$41 million respectively.

The revaluation exercise also covered business premises/ investment properties reclassified as properties held for sale. In accordance with HKFRS 5, there was no revaluation gain/loss recognised through the income statement.

Customer Group Performance

The table below sets out the profit before tax contributed by the customer groups for the years stated.

Figures in HK$m	**Personal Financial Services**	**Commercial Banking**	**Corporate Banking**	**Treasury**	**Other**	**Total reportable segments**
Year ended 31 December 2009						
Profit before tax	**7,258**	**2,637**	**915**	**3,393**	**1,274**	**15,477**
Share of profit before tax	**46.9%**	**17.0%**	**5.9%**	**21.9%**	**8.3%**	**100.0%**
Year ended 31 December 2008						
Profit before tax	8,410	2,470	645	2,279	2,074	15,878
Share of profit before tax	52.9%	15.6%	4.1%	14.4%	13.0%	100.0%

Personal Financial Services ("PFS") reported a profit before tax of HK$7,258 million for 2009, 13.7 per cent lower than in 2008. Operating profit excluding loan impairment charges was down 11.9 per cent at HK$7,457 million. In the second half of 2009, the business experienced a moderate rebound amid steadying economic conditions and improving market sentiment. Profit before tax and operating profit excluding loan impairment charges for the second half of 2009 were up 9.3 per cent and 8.4 per cent respectively compared with the first half.

Despite the excessive liquidity driving down market interest rates, PFS managed to partly offset the effect of compressed deposit spreads and the repricing of the mortgage portfolio by successfully deploying the commercial surplus to achieve growth in the secured and unsecured lending portfolios. Net interest income for the year declined by 5.8 per cent, but increased by 4.1 per cent in the second half compared with the first half.

Total operating income from unsecured lending business recorded year-on-year growth of 16.0 per cent, underpinned by the increase in the number of credit cards in force as well as card spending and receivables. Effective marketing campaigns helped the Bank gain market share and the card base grew by 6.5 per cent to 1.85 million cards in use. Card receivables rose by 7.6 per cent compared with a year earlier to HK$13.8 billion, outperforming market peers. Personal lending was up 9.3 per cent, with a total loan balance of HK$3.6 billion.

The Bank's residential mortgage business sustained its market leadership in the active property sector and gained market share despite intense competition. The Bank ranked second for the provision of equitable mortgages in Hong Kong throughout 2009 and, at 31 December 2009, its market share in terms of total mortgage loans stood at 15.1 per cent.

PFS's prudent credit strategy and improvements in unemployment and bankruptcy trends beginning in mid-2009 saw loan impairment charges drop by 34.3 per cent in the second half of the year compared with the first half.

Against the backdrop of new rules governing the physical segregation of banking and investment services, the improving market sentiment in the second half of the year helped support investment business momentum. Securities brokerage business and investment funds business registered a 29.3 per cent and 236.1 per cent increase in turnover in the second half of 2009 compared with the first half of 2009. Although non-interest income fell by 15.4 per cent compared with 2008, growth of 13.5 per cent and 52.7 per cent was achieved in the second half of 2009 compared with the first half of 2009 and the second half of 2008 respectively.

Wealth management income was broadly in line with 2008 at HK$4,672 million, representing a slight drop of 2.4 per cent.

Sales of wealth management products improved as the effects of financial stimulus policies introduced in Hong Kong started to take effect and help stabilise market conditions. In the very low interest rate environment, the Bank capitalised on growing investor appetite for lower-risk yield-enhancement opportunities. Turnover of our foreign exchange-linked investment deposits in 2009 exceeded HK$130 billion – more than triple that recorded in 2008.

Income from life insurance business grew by 46.8 per cent. Diversification of the product range with the launch of new plans that offer improved protection propositions proved effective in driving sales. Total policies in-force and total annualised premiums rose by 10.1 per cent and 14.7 per cent respectively.

Personal e-Banking continued to grow steadily with over 980,000 registered customers at 31 December 2009 – a 12.8 per cent increase compared with the end of 2008. Customers continued to support the Bank's environmental protection efforts with a 54.5 per cent increase in the number of accounts switching to the e-statement service during the year to reach more than 330,000. Hang Seng was among the first banks in Hong Kong to launch a mobile phone-based travel insurance application service and introduce touch screen technology in its network of self-service terminals.

Commercial Banking ("CMB") reported a 6.8 per cent increase in profit before tax to reach HK$2,637 million in the face of challenging market conditions. CMB's contribution to the Bank's total profit before tax increased to 17.0 per cent, up 1.4 percentage points from a year earlier. Operating profit excluding loan impairment charges was down 15.5 per cent at HK$1,989 million, due mainly to falling deposit spreads in the low interest rate environment. On the back of improving market conditions and a continuing emphasis on vigilant risk management, loan impairment charges fell significantly by 67.4 per cent.

With upturns in economic activity and the property market during the second half of 2009, customer advances rose by 12.1 per cent. Assisted by the establishment of a dedicated deposit service team and the influx of liquidity into the market, customer deposits recorded notable growth of 26.0 per cent. However, the positive impact of this growth in advances and deposits was more than offset by continuing pressure on deposit margins, resulting in a year-on-year decline of 16.6 per cent in net interest income.

CMB continued to develop its corporate wealth management business, enjoying particular success with corporate life insurance products which offered customers diversified insurance solutions, comprehensive protection, customised benefits and flexible payment options.

An Executive Retention Insurance Plan for business owners who want to retain key executives with additional benefits was launched towards the end of the year. Income from corporate life insurance recorded impressive growth of 103.1 per cent. Business momentum was sustained in investment services with more defensive investment instruments and treasury hedging solutions that served customers' business needs in the prevailing economic conditions. These initiatives helped mitigate the unfavourable impact of the overall fall in investment activity, with corporate wealth management income recording a small decline of 1.8 per cent. Corporate wealth management income contributed 13.2 per cent to CMB's total operating income in 2009.

In response to the announcement of the pilot Renminbi Trade Settlement Scheme by the Central Government on the Mainland, CMB launched a series of renminbi trade settlement services in July to support the cross-border renminbi trade between Hong Kong companies and designated mainland enterprises in the five pilot cities (Shanghai, Shenzhen, Guangzhou, Dongguan and Zhuhai). This enhanced product suite was further supported by an agreement signed with China Export and Credit Insurance Corporation (SINOSURE) in December, which reinforces CMB's capability to offer one-stop buyer credit protection and accounts receivable financial solutions. Close collaboration with Hang Seng China and the Bank's strategic partners on the Mainland also put CMB in a stronger position to capture a growing share of cross-border business flows.

With strong roots in its local communities, the Bank continued to be an active player in government-backed schemes to support small and medium-sized enterprises facing tough economic times. Since the launch of the SME Loan Guarantee Scheme and Special Loan Guarantee Scheme in late 2008, the Bank has approved over 5,000 applications with a total loan amount of more than HK$14.2 billion and with market shares in the SME Loan and Special Loan schemes of 33.3 per cent and 15.2 per cent respectively.

CMB customers continued to switch to online and automated banking channels. In December, CMB enhanced its Business e-Banking proposition with the launch of online investment fund trading services. At 31 December 2009, over 77,000 customers had registered for the Bank's Business e-Banking service, up 19.0 per cent compared with a year earlier. The number of online business transactions grew by 13.3 per cent. Branch counter transactions fell by 14.6 per cent compared with 2008.

Corporate Banking ("CIB") capitalised on its in-depth understanding of the market and its customers to support funding needs in a tight credit market, particularly in early 2009. As the economic environment stabilised, more lenders returned to the market, leading to keener competition for loans business. Despite this, CIB managed to maintain good loan asset portfolios – priced in line with conditions in the credit market – both in Hong Kong and on the Mainland, resulting in a 41.5 per cent increase in loan interest income compared with 2008 despite a 5.6 per cent decline in the total loan balance.

Competition for deposits business remained intense throughout the year. In the low interest rate environment, CIB recorded a 40.8 per cent drop in its time deposits balance. However, due to strong customer service relationships and CIB's customer profile, current and savings account deposits increased. The total deposit balance at end of 2009 was down 9.4 per cent compared with a year earlier. Deposit net interest income declined by 36.4 per cent.

Net operating income before loan impairment charges was HK$1,311 million – a year-on-year increase of 15.3 per cent. With the improved loan assets portfolio, loan impairment charges for both Hong Kong and mainland loan books were lower than in 2008. Net operating income after loan impairment charges was up 31.7 per cent at HK$1,233 million.

Treasury ("TRY") reported relatively stable operating income in 2009, recording a drop of 3.0 per cent. The favourable interest rate environment and ample liquidity in the market enabled TRY to maintain the cost of funds at a relatively low level during the year. However, the low interest rates also limited the yields that could be generated from fund deployment and balance sheet management investments. Net interest income was HK$2,162 million, down 19.4 per cent compared to 2008.

Net trading income increased substantially by HK$413 million, or 64.4 per cent, to reach HK$1,054 million, mainly attributable to a HK$462 million net increase in funding swap* income (described below). For income from sales and trading other than from funding swaps, TRY maintained business momentum by strengthening sales of foreign exchange-linked products to offset weak customer appetite for more sophisticated equity-linked and interest rate-linked structured products.

TRY maintained a prudent risk management strategy, with investment focused mainly on high-quality debt securities, particularly government-guaranteed papers and high-quality corporate securities. The credit quality of the balance sheet management portfolio improved significantly during the year, resulting in a HK$1,373 million reduction in credit risk provisions compared with 2008. This underpinned the increase of 66.8 per cent, or HK$1,275 million, in net operating income after credit risk provisions.

TRY captured opportunities in the market during the year to dispose of selected securities to achieve an improved mix of investments in the balance sheet management portfolio. While this action was in line with the Bank's prudent risk management strategy, the accompanying disposal loss of HK$152 million partly offset growth in net operating income. Profit before tax was up 48.9 per cent at HK$3,393 million, representing 21.9 per cent of the Bank's total profit before tax.

* Treasury from time to time employs foreign exchange swaps for its funding activities, which in essence involves swapping a currency ("original currency") into another currency ("swap currency") at the spot exchange rate for short-term placement and simultaneously entering into a forward exchange contract to convert the funds back to the original currency on maturity of the placement. In accordance with HKAS 39, the exchange difference of the spot and forward contracts is required to be recognised as a foreign exchange gain/loss, while the corresponding interest differential between the original and swap funding is reflected in net interest income.

Mainland Business

Hang Seng Bank (China) Limited ("Hang Seng China") opened three new outlets on the Mainland in 2009. Including a cross-city sub-branch that opened in Guangdong province under CEPA VI in January 2010, Hang Seng China now operates a network of 37 outlets in Beijing, Shanghai, Guangzhou, Dongguan, Shenzhen, Fuzhou, Nanjing, Hangzhou, Ningbo, Tianjin, Kunming, and Foshan. The Bank has a branch in Shenzhen for foreign currency wholesale business and a representative office in Xiamen.

Despite the mainland economy displaying good resilience against the effects of the global financial crisis, the economic outlook – particularly in the first half of the year – remained uncertain. Against the backdrop of a large-scale stimulus package implemented in 2009, Hang Seng China recorded notable loan growth in the second half of the year. At 31 December 2009, lending was up 5.2 per cent compared with a year earlier. With the further development of wealth management business and Commercial Banking's growing service capabilities, Hang Seng China's customer base recorded solid growth of 18.3 per cent when compared with the end of 2008, including a 25.2 per cent increase in the total number of Prestige Banking customers. These increases helped underpin a 35.9 per cent rise in the deposit base. Total operating income increased by 3.9 per cent, benefiting from the 1.3 per cent growth in net interest income. Reduced exchange losses from the revaluation of US dollar capital funds against the renminbi were partly offset by the reduction in other operating income during the year.

Hang Seng China continued to further enrich and diversify its product offerings to cater for different market conditions and to promote wealth management awareness among target customer segments. Hang Seng China has also signed an agreement with China Export and Credit Insurance Corporation (SINOSURE) that will enhance its cross-border service proposition for commercial customers.

Hang Seng China is striving to improve its network and business development efficiency by increasing its penetration in four key cities: Shanghai, Shenzhen, Guangzhou and Beijing. Resources are also being redeployed to achieve greater management and operational efficiency. Management of credit risk and operational risk continues to be strengthened through proactive risk management practices.

The Bank remains firmly committed to developing its mainland business, through both Hang Seng China and long-term relationships with mainland partners. The Bank's strategic alliance with Industrial Bank Co., Ltd. ("Industrial Bank") reached its fifth anniversary in April 2009 and continues to yield good results. Including the Bank's share of profit from Industrial Bank and Yantai Bank Co., Ltd. ("Yantai Bank"), mainland business contributed 13.3 per cent of total profit before tax, compared with 11.9 per cent in 2008.

Economic Profit

Economic profit is calculated from post-tax profit, adjusted for any surplus/deficit arising from property revaluation, depreciation attributable to the revaluation surplus and impairment of purchased goodwill and takes into account the cost of capital invested by the Bank's shareholders.

For the year 2009, economic profit was HK$8,372 million, a decrease of HK$432 million, or 4.9 per cent, compared with 2008. Return on invested capital (post-tax profit, adjusted for the property revaluation surplus net of deferred tax, depreciation attributable to the revaluation and impairment of purchased goodwill), fell by HK$971 million.

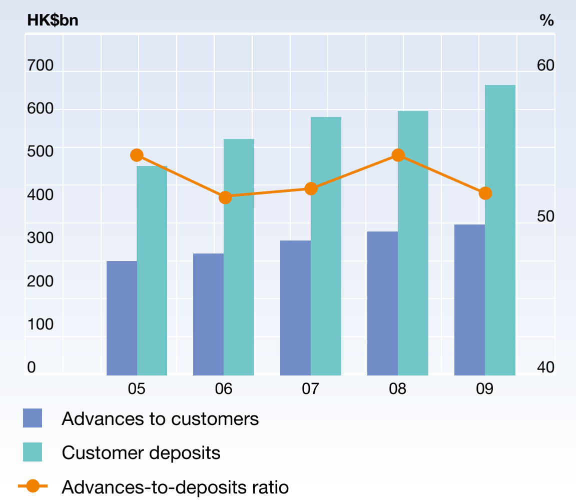
	2009		2008	
	HK$m	%	HK$m	%
Average invested capital	53,071		53,866	
Return on invested capital*	13,149	24.8	14,120	26.2
Cost of capital	(4,777)	(9.0)	(5,316)	(9.9)
Economic profit	8,372	15.8	8,804	16.3

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

Statement of Financial Position

Total assets increased by HK$63.8 billion, or 8.4 per cent, to HK$826.0 billion. In light of the weak global economy and the fact that financial markets were still recovering from the credit crisis, Treasury continued to take a highly prudent approach in managing its balance sheet management investments. Surplus funds arising from trading assets that matured in 2009 were redeployed to interbank placements and appropriate available-for-sale debt securities to attain yield enhancement. As a result, financial investments – primarily high-quality debt securities which included government-guaranteed debt securities – rose by 33.3 per cent. Customer advances recorded encouraging growth of 4.7 per cent. Despite intense market competition, the Group was able to sustain a leading position and maintained its growth momentum in residential mortgage lending and other personal lending. Mainland lending grew moderately with Hang Seng China continuing to emphasise lending quality over business expansion. Customer deposits and certificates of deposit and other debt securities in issue rose by HK$59.2 billion, or 9.8 per cent, to HK$663.7 billion, reflecting customers' lukewarm attitude towards investment and preference for liquidity in the uncertain market conditions. At 31 December 2009, the advances-to-deposits ratio was 51.9 per cent, compared with 54.4 per cent at the end of 2008.

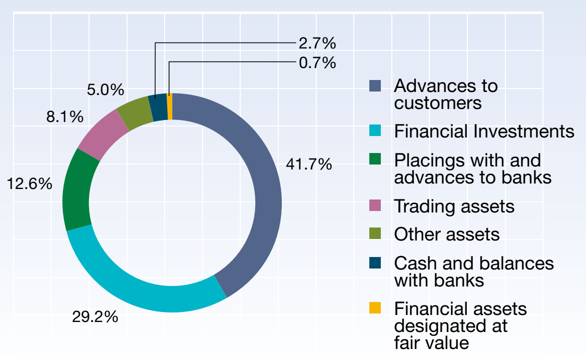
Advances to Customers and Customer Deposits



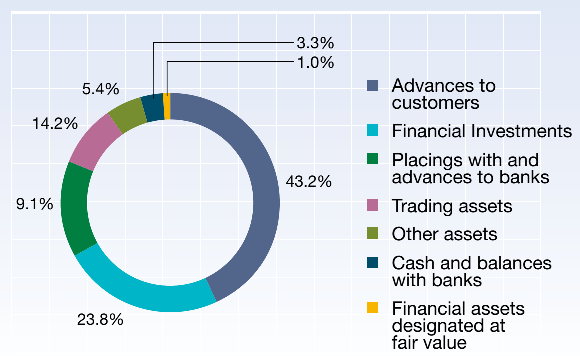
Assets deployment

Figures in HK$m	2009	%	2008	%
Cash and balances with banks and other financial institutions	22,086	2.7	24,822	3.3
Placings with and advances to banks and other financial institutions	104,551	12.6	69,579	9.1
Trading assets	66,597	8.1	108,389	14.2
Financial assets designated at fair value	5,450	0.7	7,798	1.0
Advances to customers	344,621	41.7	329,121	43.2
Financial investments	241,502	29.2	181,159	23.8
Other assets	41,161	5.0	41,300	5.4
Total assets	825,968	100.0	762,168	100.0

Assets Deployment for 2009



Assets Deployment for 2008



Advances to customers

At 31 December 2009, gross advances to customers were up HK$15.4 billion, or 4.7 per cent, at HK$346.6 billion compared with the previous year-end.

Loans for use in Hong Kong increased by HK$14.9 billion, or 5.4 per cent. New financing for corporate customers was active, reflecting strong growth in property investment lending in line with the buoyant property market. Following the Hong Kong Government's launch of two government-guaranteed lending schemes – the SME Loan Guarantee Scheme ("SGS") and the Special Loan Guarantee Scheme ("SpGS") – to facilitate financial institutions in supporting SMEs in challenging credit conditions, the Bank has actively promoted these schemes to its existing clientele and potential new customers. This boosted lending to the wholesale and retail trade sector. The decline in lending to manufacturing sector was mainly due to a large loan repayment during the year. Growth in lending to the "Other" sector was due to the increase in new financing to certain large corporate customers.

Lending to individuals increased slightly by HK$5.9 billion, or 4.5 per cent. Excluding the fall in Government Home Ownership Scheme ("GHOS") mortgages, lending to individuals grew by 7.0 per cent. Despite intense competition, the Bank was able to sustain a leading position in the mortgage market by offering comprehensive mortgage consultancy and e-mortgage services to capitalise on new business opportunities in the booming property market and the low interest rate environment. Riding on this momentum, residential mortgage lending to individuals grew by a remarkable 7.8 per cent. Sustained strong customer spending saw card advances increase by 7.6 per cent. The Bank gained market share during the year, supported by a 6.5 per cent rise in the number of cards in issue and a 9.1 per cent increase in cardholder spending. Loans to other individuals remained broadly the same as in 2008.

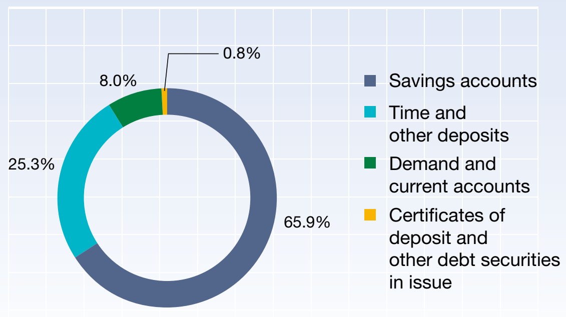
Despite the contraction in global trade activity, trade finance was able to achieve modest growth against 2008 year-end, reflecting the Bank's success in broadening its range of product and service offerings for SME customers in Hong Kong, the Mainland and Macau.

Loans for use outside Hong Kong grew by 1.0 per cent. This was due largely to the 5.2 per cent expansion in the Mainland loan portfolio, which had reached HK$28.3 billion at 31 December 2009. In the uncertain credit environment, the Group took a prudent approach in extending its lending business on the Mainland.

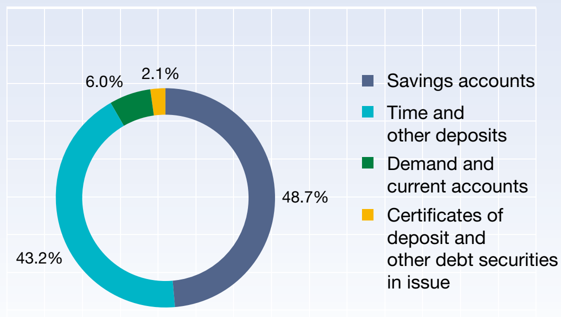
Customer deposits

Customer deposits and certificates of deposit and other debt securities in issue stood at HK$663.7 billion at 31 December 2009, a rise of 9.8 per cent over the end of 2008. Higher growth was recorded in savings and current account balances, reflecting customer preference for liquidity in the prevailing low interest rate. Structured deposits and other structured certificates of deposits and other debt securities in issue fell, due primarily to reduced demand for such products in the uncertain investment environment. Deposits with Hang Seng Bank (China) Limited rose significantly by 35.9 per cent.

Customer Deposits for 2009



Customer Deposits for 2008



Subordinated liabilities

There was no subordinated debt issued during 2009. The outstanding subordinated notes, which qualify as supplementary capital, serve to help the Bank maintain a more balanced capital structure and support business growth.

Shareholders' funds

Figures in HK$m	**2009**	2008
Share capital	**9,559**	9,559
Retained profits	**37,719**	32,518
Premises revaluation reserve	**3,994**	3,711
Cash flow hedge reserve	**174**	562
Available-for-sale investment reserve		
– on debt securities	**(496)**	(4,137)
– on equity securities	**239**	314
Capital redemption reserve	**99**	99
Other reserves	**3,303**	3,264
Total reserves	**45,032**	36,331
	54,591	45,890
Proposed dividends	**3,633**	5,736
Shareholders' funds	**58,224**	51,626
Return on average shareholders' funds	**24.6%**	26.0%

Shareholders' funds (excluding proposed dividends) grew by HK$8,701 million, or 19.0 per cent, to reach HK$54,591 million at 31 December 2009. Retained profits rose by HK$5,201 million, mainly reflecting the growth in 2009 profit after the appropriation of interim dividends and the increase in actuarial gains on the defined benefit scheme. Against the backdrop of the rebound in the property market during the year, the premises revaluation reserve increased by HK$283 million compared with 2008.

In accordance with accounting standards, available-for-sale debt and equity securities should be measured at fair value. The carrying amounts of the various debt and equity securities are reviewed at the end of the reporting period to determine whether there is any objective evidence of impairment. If evidence exists, the relevant carrying amount is reduced to the estimated recoverable amount by means of an impairment charge to the income statement.

The available-for-sale investment reserve for debt securities showed a deficit of HK$496 million compared with a deficit of HK$4,137 million at 2008 year-end, reflecting the improvement and stabilisation in global credit markets and the disposal of high-risk assets under the Bank's prudent risk management strategy. The Group assessed that there were no impaired debt securities during the year, and accordingly, no impairment loss has been recognised.

The return on average shareholders' funds was 24.6 per cent, compared with 26.0 per cent for 2008.

There was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's securities in 2009.

RISK MANAGEMENT

The effectiveness of the Group's risk management policies and strategies is a key success factor. Operating in the financial services industry, the most important types of risks the Group is exposed to are credit, liquidity, market, legal, operational, reputational and strategic. The Group has established policies and procedures to identify and analyse risks and to set appropriate risk limits to control this broad spectrum of risks. To further enhance the Bank's risk management framework and in line with best practices, the Bank has set up a Risk Management Committee to centralise the risk management oversight function of the Bank. The Risk Management Committee is constituted by the Board but reports to the Executive Committee. Its main functions are to review, analyse, evaluate, recognise and manage various risks of the Bank and is responsible for approval of all risk management related policies and major control limits. Risk limits are monitored and controlled continually by dedicated departments by means of reliable and up-to-date management information systems. The management of various types of risks is well coordinated at the level of the Bank's Board and various Management committees, such as, the Executive Committee, Risk Management Committee, Asset and Liability Management Committee and Credit Committee.

Note 62 "Financial risk management" to the financial statements provides a detailed discussion and analysis of the Group's credit risk, liquidity risk, market risk, insurance risk, operational risk and capital management. The management of reputational risk is set out as follows:

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

The Group is a socially and environmental responsible organisation. Its corporate social responsibility policies and practices are discussed in the corporate responsibility section of this annual report.