CHIEF EXECUTIVE'S REPORT

The global economic uncertainties in the second half of 2011 posed significant challenges to the banking sector.

Our strong financial fundamentals, relationship building strategies and capture of new business opportunities helped us achieve a solid operating result. Operating profit excluding loan impairment charges increased by 1% to HK$14,621m for the year and grew 1% in the second half of the year compared with the first half.

Amid intense market competition, our commercial and corporate banking businesses recorded strong growth. The further enhancement of our cross-border operations to support business customers reinforced our leading position in the provision of renminbi financial services. This was offset by lower revenues in Retail Banking and Wealth Management, particularly as income from our wealth management services declined given the weaker investor sentiment in the second half of 2011.

Our wholly owned subsidiary Hang Seng Bank (China) Limited delivered encouraging results as we tapped China's expanding economy and rising personal incomes.

Our cost efficiency ratio remained among the lowest in the industry. In order to improve operational efficiency and facilitate customer convenience, internet-based banking platforms were further strengthened. At the year-end, our Personal e-Banking and Business e-Banking customer bases were up 12% and 16% respectively, compared with a year earlier.

FINANCIAL PERFORMANCE

Total assets rose by HK$58.5bn, or 6%, to HK$975.4bn. Customer advances increased by 2%, with growth in the commercial and corporate lending businesses, while we maintained sound loan quality. The trade finance business declined as certain trade finance loans matured in the second half of the year. Customer deposits, including certificates of deposit and other debt securities in issue, rose by 5%, driven in part by strong growth in renminbi deposits. Reflecting the deployment of the commercial surplus to high-quality treasury bills and debt securities for yield enhancement, financial investments and trading assets increased by 5% and 146% respectively.

LEADERSHIP

Margaret Leung
Vice-Chairman and
Chief Executive

Operating profit rose by 1% to HK$14,181m, while the increased contribution from our associates and higher gains on revaluing investment properties led to an increase in profit attributable to shareholders of 12% to HK$16,680m.

Net interest income rose by 10% to HK$15,736m due to a 10% growth in average interest-earning assets, improved loan spreads and higher contribution from balance sheet management, partly offset by increased deposit costs. The net interest margin was maintained at 1.78%, the same level as in 2010. At 1.80% in the second half of the year, the net interest margin was up five basis points from the first half.

Affected by the unfavourable investment climate, non-interest income declined by 9%, compared with 2010. Net fee income decreased slightly by 1%, with income from the wealth management business dropping by 6%. Card services income grew by 15% as we increased our market share in terms of card base in the competitive business. Fee income from credit facilities rose by 30%, due mainly to higher fees from increased corporate lending.

Trading income decreased by 13% to HK$1,796m. The 4% increase in foreign exchange income was partly offset by reduced income from funding swap activities.

While continuing to exercise a high degree of prudence in managing costs, investment for future growth led to a 7% rise in operating expenses. Our cost efficiency ratio remained low at 35.0%, compared with 33.7% a year earlier. Excluding our Mainland operations, operating expenses rose by 5% and the cost efficiency ratio was 32.0%.

Loan impairment charges registered an increase of HK$50m, or 13%, to HK$440m, mainly due to the increase in collectively assessed impairment charges.

Reflecting our good credit risk management, total loan impairment allowances as a percentage of gross advances to customers decreased to 0.35% at the end of 2011, compared with 0.39% a year earlier. Gross impaired advances as a percentage of gross advances to customers fell to 0.33%, compared with 0.42% at the end of 2010.

CUSTOMER GROUPS

Retail Banking and Wealth Management reported profit before tax of HK$6,623m, down 16% from 2010. Operating profit excluding loan impairment charges was HK$6,441m, a drop of 18% from a year earlier.

Net interest income recorded a year-on-year decline of 4% as market competition levied pressure on deposit income. Higher interest rates were offered to grow our deposits, resulting in a 16% drop in net interest income from deposits, compared with 2010.

With a quality credit card customer base, income from unsecured lending remained a key income driver and grew by 11%, compared with 2010. The card base increased by 10% to 2.23 million during the year. Card spending and receivables rose by 16% and 18% respectively. Personal loan balances were up 15%.

Repricing of our mortgage portfolio affected our market share initially. However, our market share in Hong Kong in terms of new registrations rebounded to reach 19% in December 2011.

We continued to enhance our role as a prominent provider of insurance coverage by offering improved protection propositions. Life insurance annualised new premiums increased by 12% and total policies in force grew by 8%, compared with 2010. Despite the strong sales, income from insurance fell as market conditions led to lower investment returns on the life insurance fund portfolios.

The euro debt problem intensified in the second half of 2011. This severely affected investment appetite leading to lower distribution income from investment services, as reflected by slower fund sales and securities broking activities in the second half of the year. Income from investment services for the year fell by 11% year-on-year.

We intend to reinforce our role as a key player and pioneer in renminbi services.

Brand awareness of our private banking services was enhanced. The Bank was named the Best Local Private Bank by *Euromoney* and the Best Private Bank in Hong Kong by *Private Banker International*.

Commercial Banking achieved an increase of 34% in profit before tax to HK$5,031m. Operating profit excluding loan impairment charges was up 29% to HK$3,442m.

Net interest income increased by 26% while non-interest income grew by 13%. Customer deposits grew by 5% during the year.

Various initiatives to grow fee income achieved satisfactory results, notably from loan-related fees, remittances and corporate wealth management. Our competitive corporate wealth management products, targeting the top-end customer segment in particular, provided enhanced corporate investment, insurance and treasury products to capture the shift in investment sentiment as well as meet customers' yield enhancement or hedging needs. Income from corporate wealth management rose by 15% and contributed to 13% of Commercial Banking's net operating income.

We continued to take advantage of the growth in renminbi trade settlement. Besides close collaboration between colleagues in Hong Kong and the Mainland, we also cooperate with strategic partners on the Mainland to enhance our cross-border services. This proved to be a valuable source of referral business. At the end of 2011, we had over 70,000 commercial renminbi accounts in Hong Kong and renminbi cross-border trade-related business routed through the Bank had increased.

We expanded our network of Business Banking Centres by three to a total of seven, to reach more customers, especially SMEs. The Commercial Banking customer base increased by 13% during the year.

With a growing online customer base, the number of Business e-Banking transactions grew by 14%, compared with 2010.

Corporate Banking achieved growth of 46% in profit before tax to HK$1,843m. Operating profit excluding loan impairment charges rose by 42% to HK$1,794m. The profit growth was mainly attributable to increases in net interest income and non-interest income, which rose by 39% and 14% respectively.

Against a backdrop of tightening market liquidity, we built on our strong industry knowledge, effective risk management as well as dedicated business teams in Hong Kong and on the Mainland to achieve selective growth of 10% in customer advances. Through offering total cash management solutions to customers and capitalising on an efficient cross-border relationship management system, customer deposits grew by 29%.

Leveraging our well-established business infrastructure, Corporate Banking stepped up efforts to grow non-interest income, offering a wide spectrum of tailor-made treasury, hedging, wealth management and insurance solutions.

Treasury recorded a 26% increase in profit before tax to HK$4,227m, while operating profit rose by 24% to HK$2,729m. The growth in total operating income was mainly the result of an increase in net interest income which was partly offset by lower trading income.

In spite of persistently low interest rates, net interest income rose by 50% to reach HK$2,108m. The increase was attributed to a larger commercial surplus for investment as the Bank's balance sheet grew, more positioning taken in balance sheet management and the contribution from funding swap activities. It was also due to better margins for inter-bank lending in both Hong Kong and the Mainland.

Trading income fell by 14% to HK$1,001m, affected by the decrease in income from funding swap activities. However, foreign exchange trading income recorded encouraging growth, boosted in part by the growing demand for renminbi-denominated products.

MAINLAND BUSINESS

Hang Seng Bank (China) Limited recorded encouraging growth in profit before tax to HK$482m as it increased its foothold on the Mainland.

With the opening of its third cross-city sub-branch in Huizhou, Hang Seng China operated a strategically located network of 39 outlets across 14 Mainland cities at the year-end. Applications to establish a new branch in Xiamen, a sub-branch each in Beijing and Tianjin, and a cross-city sub-branch each in Guangdong's Shunde, Zhuhai and Jiangmen respectively have been approved.

Diversification of income streams will remain important.

Through focusing on the growing financial needs of target Mainland customers with rapidly rising incomes, the Mainland personal customer base increased by 21%. The enhancement of wealth management services facilitated a 26% rise in the number of Prestige Banking customers. As we capitalised on our good cross-border capabilities, the number of corporate and commercial banking customers also increased by 8%.

Driven by the expanded customer base and with continued emphasis on credit quality, advances to customers rose by 23%. Total deposits increased by 34%. Underpinned by strong growth in net interest income and other operating income, total operating income was 46% higher than in 2010.

The Mainland business contributed 22% to the Bank's total profit before tax, compared with 15% in 2010. This includes the share of profit from our Mainland investments, where our share of profit from Industrial Bank increased by about 40% during the year.

POSITIONING FOR FUTURE GROWTH

We are likely to see slower economic growth in both Hong Kong and the Mainland in 2012 amid lingering debt problems in Europe and a fragile global recovery.

In the banking sector, competition will remain strong, adding pressure to funding costs.

In this operating environment, we have charted a course for long-term growth. We will build on our market leadership, service excellence and time-to-market offerings to deepen relationships with our loyal customers and reach out to a new client base.

In our personal banking business, we will strengthen our wealth management and private banking services to satisfy customer needs at different life stages, targeting affluent and middle-class customers in particular. We will enhance our status as a preferred partner for trade-related services by building on our trade and corporate wealth management capabilities. Treasury will develop effective hedging solutions and new renminbi-related products.

The closer economic integration of Hong Kong and the Mainland, the opening-up of the Mainland market and the further liberalisation of offshore renminbi financial services offer vast opportunities. We intend to reinforce our role as a key player and pioneer in the provision of renminbi services.

In February 2012, the Bank launched the world's first renminbi-denominated gold exchange-traded fund (ETF) and Hong Kong's first renminbi ETF – the Hang Seng RMB Gold ETF. We will continue to design more renminbi products to cater for the growing investor demand in this area.

Our wholly owned subsidiary Hang Seng Securities Limited partnered with Guangzhou Securities Company Limited to apply in 2011 to set up the first joint venture securities investment advisory company under CEPA VI in Guangdong province. Subject to regulatory approval for its establishment, the joint venture will become a showcase for cooperation in this area under CEPA.

We will further expand our network on the Mainland. We intend to reach out to more affluent Mainland customers who are seeking new investment opportunities at home and in Hong Kong. We will also target Mainland business customers with high growth potential in key industries, in particular those supported under China's 12th Five-Year Plan. Our cross-border collaboration between our Hong Kong and Mainland teams will be strengthened and our referral partner network will further help us grow our client base.

Deposit growth will provide a solid foundation for our business expansion. Leveraging our strong balance sheet and credit risk management, we will prudently grow our quality loan portfolio, including renminbi lending, while maintaining a competitive pricing strategy. Diversification of income streams will remain important.

Even as we invest for future growth, cost efficiency will be improved through resource optimisation and technological advancement.

This will be my last annual report for Hang Seng as I will retire from my position as Vice-Chairman and Chief Executive and from the Board of Directors with effect from the conclusion of the Bank's Annual General Meeting to be held on 11 May 2012. It has been an honour to serve Hang Seng since 2009 and a pleasure to see it grow from strength to strength as an award-winning financial institution and caring community bank in Hong Kong and the Mainland.

I wish to express my sincere appreciation to my fellow Directors for their wise counsel and thank my colleagues for their hard work and commitment to enhancing Hang Seng's standing as a trustworthy and well-managed bank. I must also convey my heartfelt gratitude to our customers and shareholders for their continuous support.

I take this opportunity to wish my successor, Ms Rose Lee – currently Advisor, China and Hong Kong, The Hongkong and Shanghai Banking Corporation Limited – every success in her new position.

Hang Seng is firmly committed to providing superior financial solutions to our customers as their preferred service provider. In the challenging operating environment, we are confident that as a financially-strong, forward-looking bank, our business strategies will drive steady growth in the long term.

Margaret Leung
Vice-Chairman and Chief Executive
Hong Kong, 27 February 2012