

# CHIEF EXECUTIVE'S REPORT

The operating environment for the banking sector has been challenging this year. The turbulence in the global financial market originating from the US subprime debacle has dealt a severe blow to the US economy with pervasive ramifications for economies worldwide. Back home, various macroeconomic measures taken by the Mainland authorities to cool the overheated Chinese economy have, as targeted, softened its growth pace. Although domestic consumption and external trade remained robust in the first few months of the year, investment sentiments were far less bullish. As the IPO boom subsided, the volume of stock trading activities plunged. The property market also slowed down after an active first quarter. Meanwhile, cost management has become an increasingly thorny issue for the business sector because of mounting inflationary pressure.

Notwithstanding the above challenges, the Group succeeded in growing most of its core businesses and delivered satisfactory operating results in the first half of 2008 versus the same period last year. Our business development and income-generating capabilities have remained sound. With the continued implementation of our Relationship-Product-Channel (RPC) business model, we have been able to forge ahead with the growth strategies under the Group's current strategic plan, grow our operating income, maintain our market lead in key areas, expand into new areas and build up a stronger presence in the Mainland market.

## Business Highlights

The following summary highlights our key business results in the interim period:

- Our core businesses recorded satisfactory growth year-on-year. Total operating income rose by a healthy margin, driven by the rise in net interest income, net fees and commission income as well as net trading income.
- We achieved broad-based and strong growth in our core lending business which covers corporate loans, consumer loans and residential property mortgage.

- Further progress was made in high-margin segments such as trade finance, SME loans and Mainland lending while our credit card business continued to expand.
- We maintained our leading positions in loan syndication, residential property mortgage and RMB-related banking in the Hong Kong market.
- Wealth management business continued to grow as our high net-worth customer base expanded.
- Through the implementation of our dualistic business model in China, the Group's Mainland business recorded solid growth in operating income and further expanded its branch network.
- As BOC Group's Asia-Pacific Syndicated Loan Centre, the Group has been making substantial contribution to the whole BOC Group's loan syndication business while reinforcing the Group's market leadership in Hong Kong, Macau and the Mainland.
- The Group's total asset base continued to expand while loan quality further improved.

## Financial Performance

In the first half of 2008, the Group's net operating income before impairment allowances went up by 16.4% year-on-year to HK\$14,039 million, which was driven by the growth of net interest income, net fees and commission income as well as net trading income. Operating profit before impairment allowances grew by a healthy 15.1% year-on-year to HK\$9,951 million.

After a relatively strong 2007, profit attributable to shareholders dropped by 5.1% to HK\$7,088 million. This decline was caused mainly by a higher level of impairment allowances provided for this period. Owing to the prevailing uncertainties and gloomy sentiments in the capital market that have a negative impact on the value of its investment in the US asset-backed securities, the Group provided for a net charge of HK\$2,149 million of impairment allowances for our US asset-backed securities

in the investment portfolio. This factor inevitably eroded our net profit for this period.

Return on average total assets (ROA) and return on average shareholders' funds (ROE) were 1.32% and 15.09% respectively, versus 1.57% and 17.32% respectively for the same period in 2007. ROA and ROE before impairment allowances improved by 0.05 percentage point and 1.13 percentage points respectively to 1.83% and 21.18% respectively.

Net interest income grew by 12.6% to HK\$10,029 million because of a corresponding growth in interest-earning assets. The growth of interest-earning assets was primarily driven by the expansion of the Group's lending business and increased customer deposits. Net interest margin stayed flat at 2.03%, but this was after taking into consideration BOCHK's role as the local RMB clearing bank. As RMB deposits taken by the participating banks in Hong Kong recorded a substantial rise, their impact on our net interest margin became more material. Should this factor be discounted, the Group's net interest margin would have increased to 2.10%, up 3 basis points versus the same period last year.

We recorded an encouraging growth of 15.1% in loans and advances to both corporate and personal customers. Corporate loans increased by 19.1% while residential mortgage loans were up 9.0%. Other consumer lending, including personal loans, also recorded double-digit growth. We have remained the market leader in loan syndication and residential property mortgage. More importantly, benefiting from our enhanced business platform and extensive branch network, we have continued to grow the high-margin loan segments. Trade finance surged by a strong 30.5%. SME loans increased by 16.1%. Loans extended through our Mainland operation increased by 17.2%. The Group's loan-to-deposit ratio was up by 6.15 percentage points during the interim period to 57.81% as the growth of loans outpaced that of deposits.

Despite the sluggish market environment, we continued to pursue the growth of fee-based income with success.

The Group's net fees and commission income increased by 10.1% year-on-year to HK\$2,899 million. Fee income from our loan business more than doubled to HK\$263 million as our loan portfolio expanded substantially during the period under review. Fee income from our card business, RMB-related business, currency exchange, trust services and bills service all grew strongly. The inception of our custody business and the Group's appointment as the BOC Group's Asia-Pacific Syndicated Loan Centre earlier this year also contributed to the growth of our fee income.

After an exceptionally bullish 2007, stock trading fee income experienced a decline of 2.6% versus the first half of 2007 and 42.4% versus the second half of 2007 as the investment market was prevailed over by widespread pessimistic sentiments. At the same time, income from sales of funds plunged by 54.1% as business volume contracted. However, we still managed to grow our fee income from the distribution of bonds by a phenomenal 238.5% year-on-year.

We recorded very impressive growth in our net trading income, which surged by 196.6% year-on-year to HK\$1,237 million mainly because of the nearly 5-fold increase in net trading income from foreign exchange and related products. This phenomenal growth was attributable to the increase in business volume as well as the reduction of marked-to-market loss of foreign exchange swap contracts.

Through product innovation and effective marketing, net insurance premium income grew strongly by 53.5% to HK\$4,501 million. The growth of premium income from single-premium products was particularly impressive.

On the expenditure front, we have continued to manage our operating costs prudently and maintained our cost-to-income ratio at an optimal level. During the period under review, total operating expenses went up by 19.6% to HK\$4,088 million. This increase was caused mainly by pay rise as well as the addition of manpower needed for business growth and development in both our local and Mainland operations. Other contributing factors were

increases in operating expenses for business expansion and higher depreciation arising from our continued investment in infrastructure and equipment for service enhancement. However, the Group's cost-to-income ratio still stood at the low level of 29.12% during the interim period.

As at end-June 2008, the Group's total assets reached HK\$1,127.2 billion, up 7.6% year-on-year and 5.6% versus end-December 2007. With rigorous risk management and effective internal control, our asset quality remained excellent. The Group's classified or impaired loan ratio at end-June 2008 was 0.34%, down from 0.44% as at end-2007.

Our capital and liquidity positions remained strong. Consolidated capital adequacy ratio as at end-June 2008 was 13.87%, up from 13.08% as at end-2007, owing to the enlargement of our total capital base, which grew by 13.0% after a subordinated loan of Euro 660 million granted by BOC in June 2008. The Group's average liquidity ratio remained healthy at 42.47%, compared to 50.08% in the first half of 2007. The drop was caused mainly by the decline in average liquefiable assets, due to decreased marketable debt securities, and the increase in average qualifying liabilities as a result of the growth of deposits from customers.

### **Business Review**

Our business performance in the first six months speaks for the strength of the Group's current business model and reinforced business platform in driving growth at a steady pace even in a less favourable market environment.

#### ***Personal banking***

The performance of the Group's Personal Banking business was mixed in the interim period. It registered a drop of 5.0% in its operating income in the first half of this year after an exceptionally strong 2007. Net interest income decreased by 13.3% to HK\$3,330 million mainly due to narrower deposit spread. Other operating income, however, increased by 8.6% to HK\$2,532 million. Although income from stock brokerage and sales of funds declined in a gloomy market, the Group's net fees and commission income rose by 5.1% because of the growth in the sales of bonds, RMB-related business, card business and currency exchange business. Foreign exchange

income, in particular, surged significantly because of a robust growth in business volume. Profit before taxation decreased by 16.2% to HK\$2,965 million.

Despite fierce competition in the market, we have maintained the growth of our residential mortgage business, which increased by 9.0% in the interim period with the introduction of a number of innovative mortgage products. Meanwhile, four new Mortgage Advice Centres have been set up in selected locations to support business growth by offering professional consultancy. All these efforts ensured that we outperformed the industry in the underwriting of new mortgages and maintained our lead in the market. As a result, the Group received due recognition from the market for its outstanding mortgage service.

Although the stock-related agency business was adversely affected by the stock market's virtual slump, we managed to maintain the growth of fee income through product innovation and business platform enhancement. In fact, we have been able to expand and reinforce our bond and life insurance agency businesses considerably in the past few months. The Group continued to expand its range of structured products and at the same time enhanced its private placement services, leading to a remarkable growth in the sales of structured notes by 200.2%.

The Group's insurance agency business witnessed robust growth in the first six months this year. Supported by product innovation, strengthened marketing, upgraded service quality and enhanced operational efficiency, the sales of life insurance products and related commission income rose by 64.7% and 70.0% respectively versus the same period last year.

The Group has been proactive in driving the growth of its wealth management business. Competitive marketing campaigns and incentive programmes were staged to grow its high net-worth customer base. As a result, the number of wealth management customers grew by a hefty 14.4% in the first half of the year.

The expansion of the Group's credit card business was on track as private consumption remained active in Hong Kong. Card issuance grew by 5.4% while cardholder

spending and merchant acquiring volume increased by 17.2% and 23.2% respectively. Such encouraging performance of our card business was the fruit of our credit card unit's creative product development and marketing efforts to seize business opportunities arising from the Beijing Olympics and other avenues. Concurrently, our card business in the Mainland continued to grow through product enhancement. We also benefited from the support available from BOC Services Company Limited, a joint-venture formed between BOC-CC and BOC in November 2007.

We have remained the market leader in the RMB-related banking business in Hong Kong. New services were launched in the interim period to cater to the rapid growth in demand for RMB deposits, which more than doubled during these six months and we have continued to enjoy the largest market share in RMB deposit-taking. Our RMB credit card also recorded solid growth with card issuance increasing by 22.4% from end-2007 while cardholder spending and merchant acquiring volume surging by 66.0% and 73.2% respectively year-on-year.

We have further enhanced our e-banking channels, particularly those serving investment functions, to support business growth. In the first six months of this year, the number of e-banking customers grew by 6.2% while stock trading transactions carried out through e-banking accounted for 77.5% of the total transaction.

### **Corporate Banking**

The Group's Corporate Banking business recorded a solid growth of 11.9% to HK\$4,104 million in operating income in the first half of 2008. Operating profit before impairment increased by 9.3% to HK\$3,023 million. Profit before taxation stood at HK\$2,963 million due to the reduction in loan recoveries and the increase in loan impairment allowances.

Net interest income increased by 6.0% to HK\$2,972 million versus the same period last year. This was attributable mainly to the strong growth in loans and advances, although deposit spread narrowed with the decline in interest rates. In view of the worsening of the market condition, we have adjusted our loan pricing strategy accordingly. Other operating income rose by 31.2% to

HK\$1,132 million, thanks to the strong growth in fee income from the lending business and bills business.

We continued to drive the growth of our loan syndication business during this period and maintained our leading position in the Hong Kong-Macau and the Mainland-Hong Kong-Macau markets respectively. Having been appointed as the BOC Group's Asia-Pacific Syndicated Loan Centre in January this year, we have been in a better position to explore and capture cross-border as well as regional business opportunities, which contributed to the rise in loan fee income so far this year.

We also succeeded in further growing the high-margin segments. Through service enhancement and product innovation, we grew our loans to SME customers by a very solid 16.1% compared to end-2007. We also received awards from the SME sector and the media respectively for our quality services to SMEs. At the same time, by making stronger effort in marketing and improving our operational efficiency, we expanded our trade finance business substantially with the outstanding balance up by 30.5% from end-2007. The volume of trade bills settlement went up by 44% year-on-year.

In the first half of 2008, we strengthened our cash management business through product refinement and innovation and continued to tailor-make cross-border cash management projects for Mainland enterprises seeking global expansion. Meanwhile, by actively exploring business opportunities both local and overseas, our newly established custody business has been making encouraging progress. For example, in the first half of this year, we became the custodian for a local investment fund as well as the foreign custodian for a major joint-venture investment bank for its first QDII product. We also successfully implemented several QDII mandates.

### **Mainland Business**

The Group's Mainland operation continued to record strong business growth and development under the dualistic model. Total operating income increased by a healthy 15.4% to HK\$405 million, which was driven by the growth in net interest income and net fees and commission income. Operating profit before impairment allowances fell by 7.6% primarily due to the foreign

exchange loss arising from the revaluation of Nanyang (China)'s HKD capital funds against the appreciated RMB during the period under review. Should this loss be excluded, operating profit before impairment allowances would have increased by 40.3%.

Our lending business in the Mainland registered sturdy growth in the first six months. Total advances to customers increased by 17.2% to the equivalent of HK\$35.1 billion, of which RMB loans surged by 26.0%. Loan quality remained excellent, with the classified loan ratio standing at 0.78%. Customer deposits rose sharply by 119.7% to HK\$12.7 billion.

Nanyang (China) obtained the official approval in July this year to operate RMB retail banking business in the Mainland. Approval has already been given for the opening of four new branches and sub-branches, of which one has been opened and the remaining three will follow in the coming months. In the interim period, we also rolled out new products systematically to spur the growth of our wealth management business in China while enhancing our cross-border services.

It should be noted that our cooperation with our parent, the BOC Group, has been making significant progress. To capture emerging market opportunities for mutual benefits, we worked closely with BOC on all major business fronts in product development, customer referral, establishment of joint service platform, market exploitation, as well as back-office support. Apart from the aforementioned positive results arising from our appointment as the principal bank for BOC Group's Asia-Pacific Syndicated Loan Centre, we have also been making headway in the development of wealth management and offshore banking services for Mainland customers, and the expansion of our credit card services. With the advantage of BOC's Asia-Pacific network, we have been able to extend the distribution of the Group's products in the region.

### **Treasury**

The Group's Treasury business recorded a very strong growth in operating income of 75.4% year-on-year to HK\$4,389 million. Operating profit before impairment allowances grew by an equally strong 76.4% to

HK3,958 million. Profit before taxation fell by 19.4% primarily because of a net charge of HK\$2,149 million of impairment allowances on the investment in US asset-backed securities.

Riding on its growth momentum and business development capabilities built up recently, the Group's Treasury unit continued to diversify its investment portfolio and strengthen its portfolio management this year, thus improving the return on investment in spite of the deteriorating operating environment. We also took advantage of our enhanced product development capabilities by offering a more diverse range of treasury products to satisfy customers' investment needs. In collaboration with Corporate Banking, currency-linked structured deposits were made available to corporate customers, thus boosting the sales of structured products substantially. Our own brand of equity-linked investment products was launched in January 2008.

### **Insurance**

The growth momentum of the Group's insurance segment has remained strong so far this year. Operating income was up 25.3% to HK\$3,493 million due to the hefty rise of 55.5% in net interest income and 21.1% growth in other operating income, of which net insurance premium income surged by 53.4%. On the other hand, net insurance benefits and claims went up substantially by 36.9% as a result of generation of new business. Owing to that and the 43.8% increase in operating expenses, a loss before taxation of HK\$178 million was recorded in the period under review.

The strong sales growth of the Group's insurance business was driven primarily by product innovation and an enhanced service platform. A series of single-premium products and a more diverse range of regular-pay products were rolled out in the first half of this year. Such product innovation efforts were supported by a series of marketing initiatives with impressive results. At the same time, the Group's and BOC Life's sales and distribution platform has been substantially reinforced after a team of insurance specialists was set up and stationed at the branches. We have also continued to enhance the BOC Life brand through promotional and incentive programmes.

## Outlook

Looking ahead, as increasing uncertainty looms over the US economy and the global financial market while competition and inflationary pressure intensify, we would expect the operating environment to remain challenging in the foreseeable future for the banking sector. There are already signs that the local economy is slowing down after sustaining a long period of robust growth, which might affect investment and demand. Moreover, the movement of interest rates, is likely to be volatile in the coming months.

Under such an environment, it will be important for us to adopt a more prudent approach in our business development and investment strategies. We will also exercise more rigorous risk management and control, especially in ensuring that our loan quality is healthy. At the same time, cost management remains one of our top priorities in running our business.

We will continue to ride on the Group's solid foundations and strive to grow our businesses. We will strengthen our product innovation capabilities and expand our service/product offerings to meet customers' diverse needs in the prevailing investment climate. Concurrently we will make the most of our customer relationship platform and reinforced distribution channels to drive sales.

The development of wealth management remains one of our priorities. By growing our high net-worth client base and enhancing our services, we will further expand our wealth management business in both Hong Kong and the Mainland. We will exploit the growth potential of different groups of customers through segmentation and cross-selling efforts. For instance, we have recently launched the new i-Free Integrated Account Service to offer comprehensive banking services and investment solutions to a wide spectrum of customers.

On the back of the good performance of the Corporate Banking unit in the first six months, we will drive further growth by enhancing our service to satisfy the diverse banking and financial needs of large- and medium-sized corporate customers under a "total solution" approach. We will also take advantage of our unique position to collaborate with our parent BOC to offer comprehensive services to corporate customers across the border and in the Asia-Pacific region.

In response to the changes in the market, we will enrich our portfolio of treasury products to create new demand and growth. Our progress in building the custody business and expanding our cash management service has convinced us that we are moving in the right direction. We will double our effort in growing these businesses and continue to explore other new growth areas.

In the Mainland, we will deepen our market presence by exploiting to the full the growth potential arising from our dualistic business model. Nanyang (China)'s RMB retail banking business in the Mainland is scheduled for commencement later this year. To support its long-term development, we are expanding our Mainland branch network. We will also drive the growth of our lending business and enhance our cross-border services.

The further development of our insurance will remain a key focus. We will drive the growth of sales and market share through product innovation, service enhancement and manpower development.

We will continue to optimise our distribution channels to ensure their operational efficiency and productivity can reach higher standards. We will also reinforce and expand the automated channels, including ATMs and internet banking, to cater to customers' needs and support business growth.

In concluding, I wish to emphasise that, regardless of the challenges that lie ahead in the foreseeable future, I am confident that we can count on the Group's inherent strengths and capabilities, the guidance of the Board of Directors as well as the ongoing support of our shareholders, customers and staff to move forward at a steady pace.



**HE Guangbei**

*Vice Chairman & Chief Executive*

Hong Kong, 28 August 2008