# MANAGEMENT'S DISCUSSION AND ANALYSIS

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

## Consolidated Financial Review

The Group continued to deliver strong results in the first half of 2006. Net operating income before loan impairment allowances reached the highest level since its IPO in 2002. Improvement in total operating income was underpinned by strong growth in net interest income and net fees and commission income. Notwithstanding a reduction in both loan impairment allowances write-back and investment property revaluation gain, attributable profit reached HK$7,093 million, up HK$547 million or 8.4%. Earnings per share were HK$0.6709, up HK$0.0518. Return on average total assets and return on average shareholders' funds were 1.59% and 17.63% respectively.

### *Financial Highlights*

| HK$'m, except percentage amounts | **Half-year ended 30 June 2006** | Restated Half-year ended 31 December 2005 | Restated Half-year ended 30 June 2005 |
|---|---|---|---|
| Total operating income | **13,577** | 11,465 | 10,071 |
| Net insurance benefits and claims | **(3,060)** | (1,602) | (1,760) |
| Net operating income before loan impairment allowances | **10,517** | 9,863 | 8,311 |
| Reversal of loan impairment allowances on advances | **642** | 1,210 | 1,435 |
| Net operating income | **11,159** | 11,073 | 9,746 |
| Operating expenses | **(2,971)** | (3,078) | (2,693) |
| Operating profit | **8,188** | 7,995 | 7,053 |
| Profit before taxation | **8,673** | 8,532 | 7,970 |
| Profit attributable to equity holders of the Company | **7,093** | 7,050 | 6,546 |
| Earnings per share (HK$) | **0.6709** | 0.6668 | 0.6191 |
| Return on average total assets | **1.59%** | 1.72% | 1.62% |
| Return on average shareholders' funds* | **17.63%** | 18.34% | 18.35% |
| Net interest margin | **1.84%** | 1.86% | 1.61% |
| Non-interest income ratio | **27.99%** | 27.09% | 27.79% |
| Cost to income ratio | **28.25%** | 31.21% | 32.40% |

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

Analyses of the financial performance, business operations and risk management of the Group for the first half of 2006 are set out in the following sections.

### *Net Interest Income and Margin*

| HK$'m, except percentage amounts | **Half-year ended 30 June 2006** | Half-year ended 31 December 2005 | Half-year ended 30 June 2005 |
|---|---|---|---|
| Interest income | **19,403** | 15,980 | 10,197 |
| Interest expense | **(11,830)** | (8,789) | (4,196) |
| Net interest income | **7,573** | 7,191 | 6,001 |
| Average interest-earning assets | **827,948** | 767,189 | 749,754 |
| Net interest spread | **1.43%** | 1.53% | 1.44% |
| Net interest margin | **1.84%** | 1.86% | 1.61% |

Net interest income increased by HK$1,572 million, or 26.2%, year-on-year to HK$7,573 million. Average interest-earning assets grew by HK$78,194 million, or 10.4%, to HK$827,948 million, mainly due to the increase in average deposits and funds from IPO subscriptions. Net interest margin increased by 23 basis points to 1.84% while net interest spread dropped by 1 basis point to 1.43%. Contribution from net free fund rose by 24 basis points as a result of rising interest rates.

The interest rate environment in the first half of 2006 was very different from that in the same period in 2005. After the refinement of the operation of the linked exchange rate mechanism by HKSAR government in May 2005, one-month HIBOR increased noticeably from 1.96% at end-April 2005 to 4.10% at end-Dec 2005, culminating in 4.68% in May 2006. Average one-month HIBOR increased by 217 basis points to 4.19% for the first half of 2006 as compared to 2.02% a year ago while average one-month USD LIBOR increased by 197 basis points to 4.85% during the same period. At the same time, the Group's average prime rose to 8.08% for the first half of 2006, compared to 5.25% in the same period last year, widening the average prime-to-one-month HIBOR spread by 66 basis points to 3.89% in the first half of 2006.

The Group's gross yield on average loans increased by 247 basis points year-on-year. This was attributable to higher market interest rates and the Group's conscious efforts in maintaining loan spreads despite pricing pressure arising from keen market competition. Although weighted average yield on residential mortgage portfolio, excluding Government Home Ownership Scheme (GHOS) mortgages, declined by 12 basis points to 2.52% from 2.40% below best lending rates a year ago, loan spread widened with the prime-to-HIBOR spread. Gross yield on debt securities increased by 152 basis points as the Group continued to diversify its investment portfolio to enhance yield. However, improvements in net contribution from the debt securities portfolio were held back by the flattening yield curve. While deposit spread was widened as a result of the Group's effort in managing funding costs, higher deposit rates, coupled with a shift of savings to fixed deposits, led to higher overall funding cost. For instance, average interest rates on savings and fixed deposits increased by 219 basis points and 182 basis points respectively. At the same time, average fixed deposits as a percentage of total deposits increased by 8 percentage points when compared to the first half of 2005.

Compared to the second half of 2005, net interest income increased by HK$382 million, or 5.3%. Average interest-earning assets grew by HK$60,759 million, or 7.9%. Net interest margin decreased slightly by 2 basis points while net interest spread dropped by 10 basis points. Contribution from net free fund increased by 8 basis points.

Following the relatively steep rise in the second half of 2005, market interest rates continued to move upward but at a slower pace in the first half of 2006 due to abundant market liquidity. Average one-month HIBOR increased by only 38 basis points vis-à-vis the second half of 2005. Consequently, improvement in the contribution of net free fund slowed down. As a result of the Group's effort to maintain loan yield and widening prime-to-HIBOR spread, loan spread improved. Gross yields on average loans and debt securities rose by 74 and 64 basis points respectively. Weighted average yield on residential mortgage portfolio, excluding GHOS mortgages, declined slightly by 3 basis points to 2.52% below best lending rates. Although the rise in market rates was moderate in the first half of 2006, fixed deposit spread was further widened.

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

| | **Half-year ended 30 June 2006** | | Half-year ended 31 December 2005 | | Half-year ended 30 June 2005 | |
|---|---|---|---|---|---|---|
| **ASSETS** | **Average balance HK$'m** | **Average yield %** | Average balance HK$'m | Average yield % | Average balance HK$'m | Average yield % |
| Loans to banks | **179,749** | **4.05%** | 158,228 | 3.25% | 171,158 | 1.70% |
| Interest-earning securities | **291,961** | **4.44%** | 257,702 | 3.80% | 238,807 | 2.92% |
| Loans and advances to customers | **330,963** | **5.58%** | 330,324 | 4.84% | 320,298 | 3.11% |
| Other interest-earning assets | **25,275** | **1.74%** | 20,935 | 3.60% | 19,491 | 3.61% |
| Total interest-earning assets | **827,948** | **4.73%** | 767,189 | 4.13% | 749,754 | 2.74% |
| Non Interest-earning assets | **80,012** | | 69,610 | | 70,703 | |
| Total assets | **907,960** | **4.31%** | 836,799 | 3.79% | 820,457 | 2.51% |

| | **Half-year ended 30 June 2006** | | Half-year ended 31 December 2005 | | Half-year ended 30 June 2005 | |
|---|---|---|---|---|---|---|
| **LIABILITIES** | **Average balance HK$'m** | **Average rate %** | Average balance HK$'m | Average rate % | Average balance HK$'m | Average rate % |
| Deposits and balances of banks and other financial institutions | **39,505** | **3.37%** | 32,312 | 2.63% | 33,745 | 1.90% |
| Current, savings and fixed deposits | **647,876** | **3.33%** | 606,700 | 2.61% | 587,701 | 1.22% |
| Certificate of deposits issued | **3,953** | **3.06%** | 3,794 | 3.03% | 3,806 | 2.86% |
| Other interest-bearing liabilities | **31,175** | **2.62%** | 28,084 | 2.23% | 26,650 | 1.99% |
| Total interest-bearing liabilities | **722,509** | **3.30%** | 670,890 | 2.60% | 651,902 | 1.30% |
| Non interest-bearing deposits | **33,781** | | 33,542 | | 34,286 | |
| Shareholders' funds* and non interest-bearing liabilities | **151,670** | | 132,367 | | 134,269 | |
| Total liabilities | **907,960** | **2.63%** | 836,799 | 2.08% | 820,457 | 1.03% |

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

### *Net Fees and Commission Income*

| HK$'m | **Half-year ended 30 June 2006** | Half-year ended 31 December 2005 | Half-year ended 30 June 2005 |
|---|---|---|---|
| Bills commissions | **259** | 274 | 258 |
| Loan commissions | **116** | 139 | 124 |
| Investment and insurance fee income | **858** | 558 | 581 |
| Securities brokerage (Stockbroking) | **644** | 384 | 330 |
| Asset management | **167** | 99 | 104 |
| Life insurance | **18** | 29 | 73 |
| Bonds | **29** | 46 | 74 |
| General insurance | **54** | 45 | 58 |
| Trust services | **54** | 58 | 49 |
| Payment services | **200** | 202 | 179 |
| Credit cards | **375** | 365 | 372 |
| Others | **436** | 403 | 342 |
| Fees and commission income | **2,352** | 2,044 | 1,963 |
| Fees and commission expenses | **(591)** | (551) | (510) |
| Net fees and commission income | **1,761** | 1,493 | 1,453 |

Net fees and commission income increased by HK$308 million or 21.2% year-on-year to HK$1,761 million, primarily due to the increases in commissions from stockbroking of HK$314 million or 95.2% and asset management of HK$63 million or 60.6%. The buoyant equity market and IPO activities helped boost the volume of customer transaction and the sales of open-end funds by 121.6% and 133.6% respectively. On the other hand, as customers demanded investments with higher potential returns under the prevailing interest rate environment, sales of bonds and structured notes dropped and related commission income decreased by HK$45 million or 60.8%. As a result of the combination with BOC Life, fee income from life insurance for the three half-yearly periods only included fee income from the Group's other insurance business partners after group consolidation elimination. It fell by HK$55 million, or 75.3%, mainly due to lower sales of insurance products. At the same time, the business volume of BOC Life, as reflected in the 'net insurance premium income', grew significantly after the successful launching of several new products. Loan commissions fell by HK$8 million or 6.5% due to lower business volume while bills commission remained flat. Other fees and commission income increased by HK$94 million or 27.5%, mainly due to fee income from IPO activities amounting to HK$35 million and the robust growth of fee income from RMB-related services by 111.8% and exchanges by 75.9%. In line with the increment of fees and commission income, fees and commission expenses rose by HK$81 million or 15.9% because of higher stockbroking expenses.

Compared to the second half of 2005, net fees and commission income increased by HK$268 million or 18.0% with the growth of income from stockbroking and asset management.

### *Investment and Insurance Business*

| HK$'m | **Half-year ended 30 June 2006** | Half-year ended 31 December 2005 | Half-year ended 30 June 2005 |
|---|---|---|---|
| Investment and insurance fee income | | | |
| Securities brokerage (Stockbroking) | **644** | 384 | 330 |
| Asset management | **167** | 98 | 85 |
| Life insurance | **18** | 29 | 73 |
| Bonds | **29** | 46 | 74 |
| | **858** | 557 | 562 |
| Insurance income of BOC Life | | | |
| Net insurance income* | **416** | 254 | 14 |
| Fee income | **–** | 3 | 20 |
| Interest income | **208** | 177 | 141 |
| Net trading income | **(415)** | (260) | (45) |
| | **209** | 174 | 130 |
| Total investment and insurance income | **1,067** | 731 | 692 |

* Net insurance income represents net insurance premium income deducted by net insurance benefits and claims.

Total investment and insurance income surged by HK$375 million, or 54.2%, year-on-year to HK$1,067 million, primarily due to an increase in investment and insurance fee income of HK$296 million, or 52.7%, and the rise of insurance income of BOC Life by HK$79 million, or 60.8%. The increase in BOC Life's insurance income was driven by higher net insurance income and interest income from deposits and debt securities portfolio. Net insurance income increased significantly with the growth of underwriting business which was supported by several new products. The growth was partially offset by lower fair value of interest rate instruments and structured notes as most of the securities were booked under financial assets at fair value through profit or loss.

Compared to the second half of 2005, total investment and insurance income increased by HK$336 million, or 46.0%, mainly due to an increase in investment and insurance fee income of HK$301 million, or 54.0%.

### *Net Trading Income*

| HK$'m | **Half-year ended 30 June 2006** | Half-year ended 31 December 2005 | Half-year ended 30 June 2005 |
|---|---|---|---|
| Foreign exchange and foreign exchange products | **758** | 869 | 596 |
| Interest rate instruments | **(114)** | (256) | 84 |
| Equity instruments | **(96)** | 18 | 2 |
| Commodities | **58** | 35 | 17 |
| Net trading income | **606** | 666 | 699 |

Net trading income decreased by HK$93 million, or 13.3%, to HK$606 million. Net trading income from foreign exchange and foreign exchange products grew to HK$758 million, representing an increase of HK$162 million or 27.2%. This growth was mainly attributable to the rise in the fair value of foreign exchange swap contracts. Net trading income from interest rate instruments included changes in the fair value of trading securities, other financial assets at fair value through profit or loss, available-for-sale securities designated as fair value hedges, interest rate derivatives and financial liabilities at fair value through profit or loss. In the first half of 2006, net trading income from interest rate instruments posted a net loss of HK$114 million. The major reason was the decline in the fair value of certain financial assets at fair value through profit or loss due to increase in interest rates. Equity instruments suffered a net loss of HK$96 million mainly because of the change in the market value of structured notes held by BOC Life.

Compared to the second half of 2005, net trading income dropped by HK$60 million or 9.0%, mainly due to the decrease in gains from foreign exchange swap contracts and adverse change in the fair value of structured notes.

### *Net Insurance Premium Income*

| HK$'m | **Half-year ended 30 June 2006** | Half-year ended 31 December 2005 | Half-year ended 30 June 2005 |
|---|---|---|---|
| Life and Annuity | **3,470** | 1,811 | 1,405 |
| Linked Long Term | **10** | 50 | 369 |
| Retirement Scheme | **(2)** | – | 1 |
| | **3,478** | 1,861 | 1,775 |
| Reinsurers' share of gross earned premiums | **(2)** | (5) | (1) |
| Net insurance premium income | **3,476** | 1,856 | 1,774 |

Compared to the first half of 2005, net insurance premium income registered a solid growth of HK$1,702 million or 95.9% to HK$3,476 million, driven by 70.3% growth in the number of insurance policies concluded and 21.0% growth in the premium per new policy. The strong growth of premium income was the result of the successful launch of new products during the first half of 2006.

Compared to the second half of 2005, net insurance premium income increased by HK$1,620 million or 87.3% to HK$3,476 million.

### *Net Insurance Benefits and Claims*

| HK$'m | **Half-year ended 30 June 2006** | Half-year ended 31 December 2005 | Half-year ended 30 June 2005 |
|---|---|---|---|
| Life and Annuity | **3,051** | 1,575 | 1,390 |
| Linked Long Term | **10** | 29 | 368 |
| Retirement Scheme | **–** | (1) | 2 |
| | **3,061** | 1,603 | 1,760 |
| Reinsurers' share of claims, benefits and surrenders paid and movement in liabilities | **(1)** | (1) | – |
| Net insurance benefits and claims | **3,060** | 1,602 | 1,760 |

Compared to the first half of 2005, net insurance benefits and claims increased by HK$1,300 million or 73.9% to HK$3,060 million, which was in line with the growth of life and annuity insurance underwriting business. Prospective liabilities were recognised on the basis of the assumptions made as to mortality, investment income and fair value changes in the underlying investments.

Compared to the second half of 2005, net insurance benefits and claims increased by HK$1,458 million or 91.0% to HK$3,060 million.

### *Operating Expenses*

| HK$'m, except percentage amounts | **Half-year ended 30 June 2006** | Half-year ended 31 December 2005 | Half-year ended 30 June 2005 |
|---|---|---|---|
| Staff costs | **1,823** | 1,826 | 1,667 |
| Premises and equipment expenses (excluding depreciation) | **374** | 420 | 320 |
| Depreciation | **323** | 282 | 287 |
| Other operating expenses | **451** | 550 | 419 |
| Operating expenses | **2,971** | 3,078 | 2,693 |
| Cost to income ratio | **28.25%** | 31.21% | 32.40% |

Operating expenses rose by HK$278 million, or 10.3%, year-on-year to HK$2,971 million due mainly to an increase in staff cost of HK$156 million or 9.4% following the pay rise in April 2006 and the recruitment of qualified staff. Compared to the end of June 2005, headcount measured in full time equivalents decreased by 66 to 12,715 at the end of June 2006.

Depreciation on owned fixed assets increased by HK$36 million, or 12.5%, to HK$323 million as compared to the first half of 2005, largely due to the rise in the value of premises.

### *Reversal of Loan Impairment Allowances on Advances*

| HK$'m | **Half-year ended 30 June 2006** | Half-year ended 31 December 2005 | Half-year ended 30 June 2005 |
|---|---|---|---|
| Reversal of/(Charge for) loan impairment allowances | | | |
| Individual assessment | | | |
| – new allowances | **(366)** | (609) | (695) |
| – releases | **99** | 834 | 208 |
| – recoveries | **676** | 552 | 1,087 |
| Collective assessment | | | |
| – new allowances* | **(2)** | 90 | (101) |
| – releases | **219** | 364 | 915 |
| – recoveries* | **16** | (21) | 21 |
| Net Credit to Income Statement | **642** | 1,210 | 1,435 |

* New allowances and recoveries for the half-year ended 31 December 2005 included adjustments resulted from a change in the classification of individual assessment and collective assessment of certain loans in the second half of 2005.

Loan impairment allowances of individually significant loans and advances showing objective evidence of impairment are calculated using the discounted cash flow method (Individual Assessment – IA). For the remaining loans and advances, impairment allowances are collectively assessed by using statistical models on portfolios of loans and advances grouped by similar credit characteristics (Collective Assessment – CA). Compared to the first half of 2005, the Group recorded net release of loan impairment allowances of HK$642 million, down HK$793 million or 55.3%. Release of allowances fell by HK$805 million or 71.7% to HK$318 million. The reduction in the release reflected a slowdown in the improvement in the bad debt migration rate, after the Group's significant improvement in asset quality last year on the back of improved economic conditions and borrowers' debt servicing capability. This release was offset by new impairment allowances amounting to HK$368 million. Additional allowances were needed to cover the formation of new impaired loans and further deterioration of existing impaired accounts.

In the first half of 2006, recoveries totaled HK$692 million, down HK$416 million or 37.6% when compared to the first half of 2005, which included recoveries of certain large accounts.

Compared to the second half of 2005, net release of loan impairment allowances decreased by HK$568 million or 46.9% as a result of lesser release of loan impairment allowances. The significant release in the second half of 2005 was mainly attributable to the recovery of advances to a customer.

### *Property Revaluation*

| HK$'m | **Half-year ended 30 June 2006** | Half-year ended 31 December 2005 | Half-year ended 30 June 2005 |
|---|---|---|---|
| Net (loss)/gain on revaluation of premises | **(4)** | 63 | – |
| Net gain on fair value adjustments on investment properties | **477** | 468 | 918 |
| Deferred tax | **(22)** | (184) | (155) |
| Net gain on fair value adjustments on investment properties, after tax | **455** | 284 | 763 |

The aggregate impact of property revaluation on the income statement was HK$473 million, of which HK$477 million came from the revaluation of investment properties. Loss on revaluation of premises was HK$4 million. The related deferred tax charge on revaluation of investment properties amounted to HK$22 million. As a result, the net impact on the Group's attributable profit in the first half of 2006 was HK$455 million.

### *Financial Position*

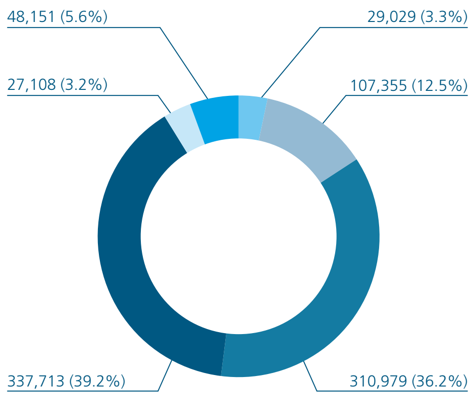
| HK$'m, except percentage amounts | **At 30 June 2006** | Restated At 31 December 2005 |
|---|---|---|
| Cash and balances with banks and other financial institutions | **29,029** | 30,704 |
| Placements with banks and other financial institutions | **107,355** | 125,862 |
| Hong Kong SAR Government certificates of indebtedness | **33,460** | 32,630 |
| Securities investments* | **310,979** | 264,209 |
| Advances and other accounts | **337,713** | 338,403 |
| Fixed assets and investment properties | **27,108** | 26,117 |
| Other assets** | **14,691** | 13,077 |
| Total assets | **860,335** | 831,002 |
| Hong Kong SAR currency notes in circulation | **33,460** | 32,630 |
| Deposits and balances of banks and other financial institutions | **46,802** | 40,655 |
| Deposits from customers | **640,891** | 632,658 |
| Certificates of deposit issued | **3,935** | 3,965 |
| Insurance contract liabilities | **10,777** | 7,968 |
| Other accounts and provisions | **41,519** | 31,413 |
| Total liabilities | **777,384** | 749,289 |
| Minority interests | **1,917** | 1,778 |
| Capital and reserves attributable to the equity holders of the Company | **81,034** | 79,935 |
| Total liabilities and equity | **860,335** | 831,002 |
| Loan to deposit ratio | **51.18%** | 52.27% |

* Securities investments comprise investment in securities, trading securities and other financial instruments at fair value through profit or loss.

** Investments in associates and derivative financial instruments are included in other assets.

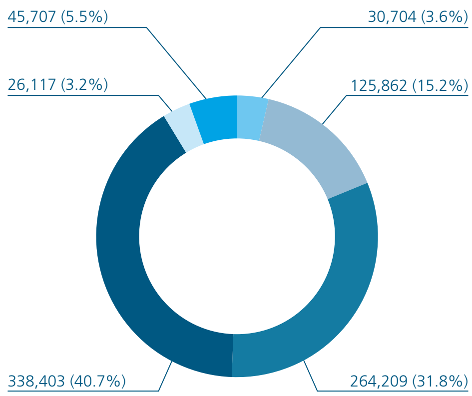
**Balance Sheet Mix as at 30 June 2006**

HK$ million/(%)




**Balance Sheet Mix as at 31 December 2005**

HK$ million/(%)




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

The Group's total assets were HK$860,335 million as at 30 June 2006, up HK$29,333 million or 3.5%, from the end of 2005.

– Cash and balances with banks and other financial institutions dropped by HK$1,675 million or 5.5%, while interbank placements fell by HK$18,507 million, or 14.7%.

– Securities investments rose by HK$46,770 million, or 17.7%, to HK$310,979 million.

– The Group continued to actively manage the balance sheet. As a result, short-term surplus funds were reduced and uses of funds by securities investment portfolio increased.

## *Advances to Customers*

| HK$'m, except percentage amounts | **At 30 June 2006** | **%** | At 31 December 2005 | % |
|---|---|---|---|---|
| Loans for use in Hong Kong | **275,597** | **82.7%** | 279,835 | 83.8% |
| Industrial, commercial and financial | **153,300** | **46.0%** | 151,903 | 45.5% |
| Individuals | **122,297** | **36.7%** | 127,932 | 38.3% |
| Trade finance | **15,809** | **4.7%** | 16,080 | 4.8% |
| Loans for use outside Hong Kong | **41,802** | **12.6%** | 38,108 | 11.4% |
| Total advances to customers | **333,208** | **100.0%** | 334,023 | 100.0% |

Total advances to customers declined marginally by HK$815 million or 0.2%. This was the result of intensified market competition particularly in the residential mortgage market. The decrease was counterbalanced by the growth in corporate loans in Hong Kong and loans for use outside Hong Kong.

Loans for use in Hong Kong decreased by 1.5%:

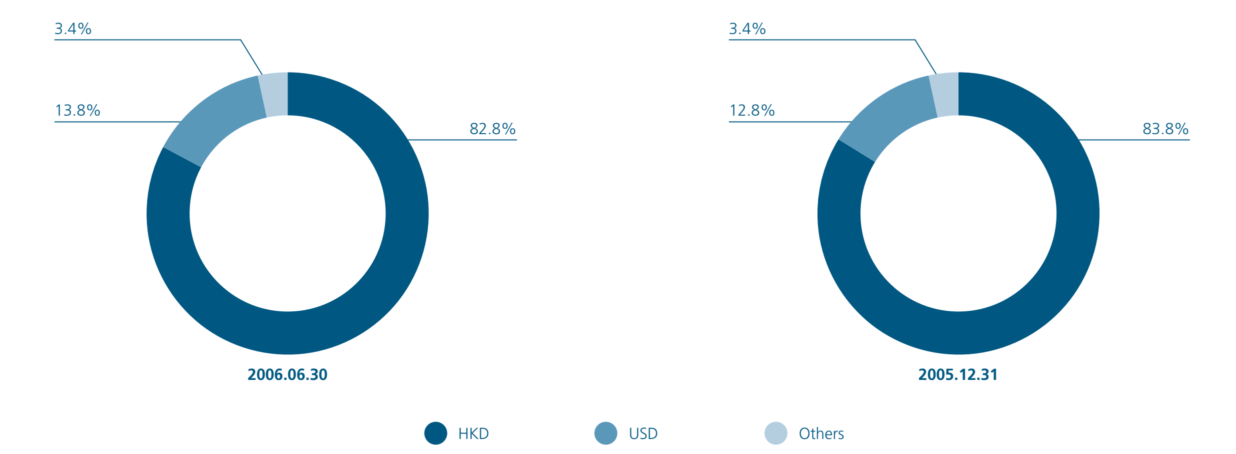
– Lending to industrial, commercial and financial sectors grew by HK$1,397 million, or 0.9%, driven by loans for property investment and manufacturing. In particular, our SME loan portfolio increased by HK$1,446 million or 3.1%.

– Residential mortgage loan (excluding those under the government-sponsored Home Ownership Scheme) declined by HK$4,729 million or 4.8% primarily due to price competition and market conditions.

– Card advances decreased by HK$128 million, or 2.7%.

Trade finance decreased by HK$271 million or 1.7%, primarily due to repayments by large corporate customers. Meanwhile, loans for use outside Hong Kong grew by HK$3,694 million or 9.7%.

**Total advances to customers by currency mix (%)**



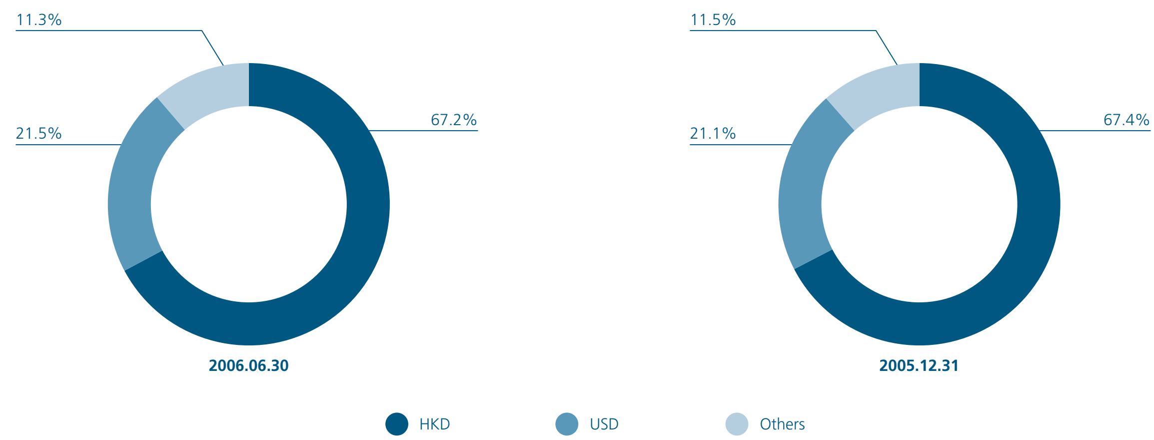

In terms of currency mix, HK dollar and US dollar advances to customers accounted for 82.8% and 13.8% respectively. Other currency advances to customers accounted for 3.4% only. There was no significant change in currency mix in the first half of 2006.

### *Deposits from Customers*

| HK$'m, except percentage amounts | At 30 June 2006 | % | At 31 December 2005 | % |
|---|---|---|---|---|
| Demand deposits and current accounts | **28,435** | **4.4%** | 28,948 | 4.5% |
| Savings deposits | **223,968** | **34.4%** | 216,540 | 33.9% |
| Time, call and notice deposits | **388,488** | **59.6%** | 387,170 | 60.6% |
| Total deposits from customers | **640,891** | **98.4%** | 632,658 | 99.0% |
| Structured deposits | **10,103** | **1.6%** | 6,373 | 1.0% |
| Adjusted total deposits from customers | **650,994** | **100.0%** | 639,031 | 100.0% |

Deposits from customers increased by HK$8,233 million, or 1.3%, to HK$640,891 million from the end of 2005. The Group has been optimising funding costs by actively controlling interest rates on fixed deposits. Demand deposits and current accounts declined by HK$513 million or 1.8%. Savings deposits rose by HK$7,428 million or 3.4% and time, call and notice deposits rose marginally by HK$1,318 million or 0.3%. There was a growing popularity in structured deposits, a hybrid of retail deposit and derivatives that gives a higher nominal interest rate to depositors. Structured deposits amounted to HK$10,103 million, up HK$3,730 million or 58.5%, representing about 1.6% of the adjusted total deposits from customers. The Group's loan to deposit ratio was 51.2% at end of June 2006.

**Adjusted total deposits from customers by currency mix (%)**




In terms of currency mix, HK dollar and US dollar deposits from customers accounted for 67.2% and 21.5% respectively. Other currency deposits from customers accounted for 11.3%. The Group's HK dollar loan to deposit ratio was 63.1%, down from 65.0% at end-2005, mainly due to the decline in HK dollar advances to customers.

## *Asset Quality*

| HK$'m, except percentage amounts | **At 30 June 2006** | At 31 December 2005 |
|---|---|---|
| Advances to customers | **333,208** | 334,023 |
| Impaired loan ratio[&] | **1.09%** | 1.28% |
| | | |
| Impairment allowances | **1,561** | 1,714 |
| Regulatory reserve for general banking risks | **3,519** | 3,526 |
| Total allowances and regulatory reserve | **5,080** | 5,240 |
| | | |
| Total allowances as a percentage of advances to customers | **0.47%** | 0.51% |
| Total allowances and regulatory reserve as a percentage of advances to customers | **1.52%** | 1.57% |
| Impairment allowances on impaired loan ratio[##] | **33.01%** | 29.77% |
| Total coverage (including collateral values)[##] | **100.41%** | 99.88% |
| | | |
| Residential mortgage loans* – delinquency and rescheduled loan ratio** | **0.26%** | 0.30% |
| Card advances – delinquency ratio**[#] | **0.33%** | 0.32% |

| | **Half-year ended 30 June 2006** | Half-year ended 30 June 2005 |
|---|---|---|
| Card advances – charge-off ratio[#] | **2.64%** | 2.87% |

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

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

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

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

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

### *Movement of Gross Impaired Advances to Customers*

| In HK$ bln | At 30 June 2006 | At 31 December 2005 | At 30 June 2005 |
|---|---|---|---|
| Beginning balance | **4.3** | 6.4 | 9.2 |
| New impaired loans | **0.4** | 0.7 | 1.0 |
| Upgraded impaired loans | **(0.2)** | (0.3) | (0.9) |
| Collection | **(0.7)** | (1.9) | (1.9) |
| Write-off | **(0.1)** | (0.5) | (0.6) |
| Others | **(0.1)** | (0.1) | (0.4) |
| Ending balance | **3.6** | 4.3 | 6.4 |

In the first half of 2006, the Group's impaired loans decreased by HK$646 million or 15.2%. Impaired loan ratio improved by 0.19 percentage point to 1.09% due to benign credit quality, strong collection and recovery efforts. Total collections amounted to approximately HK$0.7 billion. Write-off of impaired loans amounted to HK$0.1 billion. About HK$0.1 billion of the reduction in impaired loans was due to the treatment of repossessed assets as a direct offset against the impaired loans outstanding.

Total impairment allowances, including both IA and CA, amounted to HK$1,561 million. Impairment allowances for impaired loan ratio was 33.01%. If the value of underlying collateral was included, the total coverage ratio would increase to 100.41%. The Group also held a regulatory reserve amounting to HK$3,519 million.

The quality of the Group's residential mortgage loans continued to improve. The combined delinquency and rescheduled loan ratio decreased from 0.30% at end-2005 to 0.26%. The quality of card advances also improved, with the charge-off ratio dropping from 2.87% to 2.64%.

### *Capital and Liquidity Ratios*

| HK$'m, except percentage amounts | **At 30 June 2006** | At 31 December 2005 |
|---|---|---|
| Tier 1 capital | **66,079** | 64,213 |
| Tier 2 capital | **2,995** | 3,991 |
| Unconsolidated investment and other deductions | **(965)** | (1,004) |
| Total capital base after deductions | **68,109** | 67,200 |
| Risk-weighted assets | | |
| On-balance sheet | **443,191** | 412,851 |
| Off-balance sheet | **30,825** | 30,713 |
| Deductions | **(7,693)** | (6,450) |
| Total risk-weighted assets | **466,323** | 437,114 |
| Total risk-weighted assets adjusted for market risk | **466,882** | 438,213 |
| Capital adequacy ratios (banking group level) | | |
| Before adjusting for market risk | | |
| Tier 1 | **14.17%** | 14.69% |
| Total | **14.61%** | 15.37% |
| After Adjusting for market risk | | |
| Tier 1* | **14.15%** | 14.65% |
| Total* | **14.59%** | 15.33% |

| | **Half-year ended 30 June 2006** | Half-year ended 30 June 2005 |
|---|---|---|
| Average liquidity ratio | **50.30%** | 39.15% |

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

Total capital base of the Group after deduction further increased to HK$68,109 million or 1.4% over the balance at 31 December 2005, representing an increase in retained earnings. Despite this, the consolidated capital adequacy ratio of the banking group fell to 14.61% from 15.37% at end-2005 because of the 6.7% increase in total risk-weighted assets. This was the result of the growth of securities investment.

Average liquidity ratio rose to 50.30%, compared to 39.15% in the first half of 2005. The Group continued to actively manage the balance sheet. Consequently, new funds from deposits were invested in liquefiable securities, which helped strengthen the liquidity position.

## Business Review

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

## *Retail Banking*

| HK$'m, except percentage amounts | **Half-year ended 30 June 2006** | Half-year ended 30 June 2005 | Increase/ (decrease) |
|---|---|---|---|
| Net interest income | **3,812** | 3,650 | +4.4% |
| Other operating income | **1,670** | 1,202 | +38.9% |
| Net operating income before loan impairment allowances | **5,482** | 4,852 | +13.0% |
| Release of loan impairment allowances | **38** | 85 | -55.3% |
| Net operating income | **5,520** | 4,937 | +11.8% |
| Operating expenses | **(2,326)** | (2,142) | +8.6% |
| Operating profit | **3,194** | 2,795 | +14.3% |
| Others | **(5)** | – | N/A |
| Profit before taxation | **3,189** | 2,795 | +14.1% |

| | **At 30 June 2006** | At 31 December 2005 | Increase/ (decrease) |
|---|---|---|---|
| Segment assets | **156,708** | 158,844 | -1.3% |
| Segment liabilities | **539,684** | 554,244 | -2.6% |

Note: For additional segmental information, see Note 40 to the Financial Statements.

**Results**

Retail Banking posted a 14.1% growth in profit before taxation to HK$3,189 million as compared to the first half of 2005. Net operating income before loan impairment allowances increased by 13.0% to HK$5,482 million. The growth was driven by the increase of both net interest income and other operating income.

Net interest income rose by 4.4% to HK$3,812 million. The overall profitability of prime-based loans, which formed the majority of Retail Banking's loan assets, improved due to widened prime-HIBOR spread. However, it was partially offset by the decrease in average balance. The surge in interbank rates and the Group's efforts in managing funding cost improved the deposit spread and contributed to the increase in net interest income, which was partially offset by the shift in savings to time deposits.

Other operating income soared by 38.9% to HK$1,670 million, primarily driven by strong growth of net fees and commission income by 42.2% to HK$1,394 million. The active stock market accelerated the growth of transaction volume, thereby increasing the commissions from stockbroking. This, coupled with the growth of commissions from the sales of open-end investment fund, outweighed the decline in commissions from the sales of structured products.

Operating expenses rose by 8.6% to HK$2,326 million mainly because of the rise of staff cost after the salary increase in April 2006 and the increase in computer processing costs.

Advances and other accounts, including mortgage loans and card advances, decreased by 2.0% to HK$125,873 million from end-2005. Customer deposits decreased by 3.3% to HK$516,043 million.

**Growth of investment and insurance business**

Investment and insurance business, which was one of the top priorities in the Group's business development strategies, recorded encouraging results in the first half of 2006. Despite intense competition, the Group's wealth management customers and assets under management grew by 24.7% and 20.1% respectively. An active local stock market boosted the Group's stock brokerage business volume by a substantial increase of 121.6%. The IPO of Bank of China set new records in terms of both the number of applications received and processed as well as the volume of IPO financing. The sales volume of open-end funds also increased by 133.6% of which China Equity Funds and Emerging Market Equity Funds were among the best selling funds. During the first half of the year, the Group launched a series of new insurance products such as "Supreme Saver 06- 5 Year Life Endowment Plan", "Reward Plus Insurance Plan" and "Prudent Saver 5-year Life Endowment Plan", which were well received by customers.

**Residential mortgages**

The Group's residential mortgage business in the first half of 2006 was affected by keen competition and a relatively lacklustre residential property market. Against this backdrop, the Group actively promoted fixed-rate mortgage plans and HIBOR-based mortgage plans to meet customers' needs. Benefiting from the basically positive economic conditions, the credit quality of residential mortgage continued to improve as the delinquency and rescheduled loan ratio dropped further to 0.26%.

**Value-added services for high net worth customers**

In collaboration with BOC, in December 2005 the Group launched a new service which enables wealth management customers to access priority and privileged banking services at BOC branches in the whole Asia Pacific region. In addition, versatile value-added banking solutions covering investment management, financial planning and pre-arranged banking services were tailored for Mainland customers. Currently, 96 Wealth Management Prime and 18 Wealth Management VIP centres are in operation.

**Credit card business**

The Group's card business maintained its growth momentum in the first half of 2006. Cardholder spending volume and merchant acquiring volume registered growth of 7.2% and 15.0% respectively. During the first half of 2006, the Group launched "GBP Greatwall International Card" and it was the first EMV certificate acquirer in Hong Kong.

**Leadership in personal RMB banking business**

The Group remained the market leader in the Renminbi (RMB) personal banking services in Hong Kong and continued to achieve satisfactory results in RMB-related businesses. RMB deposits increased to HK$8,617 million by end-June 2006. The Group maintained its leading position in RMB card issuing business, increasing its volume by 60.3%. At the end of June 2006, the number of ATMs providing RMB withdrawal service amounted to 236. The Group was among the first batch of the banks in Hong Kong to launch expanded RMB services in December 2005. In March 2006, the Group launched Renminbi Settlement System (RSS) to provide clearing services for expanded RMB business in Hong Kong. The newly launched RSS served as a quality clearing platform and provided a solid foundation for the further expansion of RMB business. At the same time, Personal RMB Cheque Service was launched to enable customers to make payment for consumer spending in Guangdong Province by cheque.

**E-channel development**

Continuous progress was made on e-channel development by enhancing and expanding iTS internet banking functions, especially in the area of investment services. As a result, the number of iTS customers increased by 8.9% in the first half of 2006. Compared to the first half of 2005, the number of iTS transactions increased by 58.4%.

## *Corporate Banking*

| HK$'m, except percentage amounts | **Half-year ended 30 June 2006** | Half-year ended 30 June 2005 | Increase/ (decrease) |
|---|---|---|---|
| Net interest income | **1,981** | 1,777 | +11.5% |
| Other operating income | **535** | 505 | +5.9% |
| Net operating income before loan impairment allowances | **2,516** | 2,282 | +10.3% |
| Release of loan impairment allowances | **604** | 1,350 | -55.3% |
| Net operating income | **3,120** | 3,632 | -14.1% |
| Operating expenses | **(675)** | (601) | +12.3% |
| Profit before taxation | **2,445** | 3,031 | -19.3% |

| | **At 30 June 2006** | At 31 December 2005 | Increase/ (decrease) |
|---|---|---|---|
| Segment assets | **212,688** | 211,834 | +0.4% |
| Segment liabilities | **131,392** | 101,719 | +29.2% |

Note: For additional segmental information, see Note 40 to the Financial Statements.

**Results**

Corporate Banking reported a profit before taxation of HK$2,445 million, down by HK$586 million or 19.3% as compared to the first half of 2005. The decline was mainly attributable to a significant decrease in net release of loan impairment allowances. Net operating income before loan impairment allowances, however, increased by 10.3% to HK$2,516 million. Net interest income and other operating income grew by 11.5% and 5.9% respectively, partially offsetting the impact of the reduction in the release of loan impairment allowances on the segment's profit.

The rise in net interest income was achieved by widening loan spread and deposit spread. Operating expenses were up 12.3% to HK$675 million.

Release of loan impairment allowances was HK$604 million, down 55.3%, as marginal improvement in bad debt migration rate slowed down. The asset quality of the corporate loan portfolio remained strong despite the deterioration of a small number of accounts.

Loan assets in the Corporate Banking sector were stable in the first half of 2006. Advances and other accounts increased by 1.5% to HK$211,302 million. Customer deposits registered a robust growth of 28.6% to HK$127,936 million.

**Market leadership in loan syndication**

The Group continued to develop its syndicated loan business and remained as the leader in the Hong Kong, Macau and China market. According to Basis Point, a leading Asian debt market magazine, the Group was ranked second in the Hong Kong/Macau market and third in the Hong Kong/China market on the top-tier arrangers' list.

**Enlargement of SME customer base and enhancement of business competitiveness**

In 2006, the Group focused on adjusting its business and customer structures and devoted much effort in developing its SME business. The Group's 5-year SME business plan focuses on further improving the SME business model, optimising credit approval procedures for SME loans, simplifying existing workflow, and increasing efficiency of customer service. In the first half of 2006, the Group launched a series of new products to better serve SME customers, such as Equipment Link, Professional Firms Link, Trade Peak Season Link, etc. Meanwhile, the Group also promoted the Corporate Privilege Club to provide quicker and more prestigious banking services to VIP corporate customers.

**Enhancement of e-banking services and cash management business**

In order to improve cash management business, the Group continued to refine the related service platform, extend the service coverage, broaden the areas of system connection to BOC's overseas branches, and further enhance its tailor-made service plan to large corporations and provide standardised cash management products and services to SME customers. Such improvements were meant to create more business opportunities and enhance cross-selling.

The Group continued to strengthen its e-banking functions and promote CBS Online services. The number of CBS Online customers increased by 40.6% in the first half of 2006.

**Preparation for the opening of Mainland financial market**

To prepare for the opening of the financial market in the Mainland, the Group continued to strengthen its business relationship with local and overseas financial institutions. Meanwhile, the Group actively promoted QDII/QFII-related business, and all related preparations are ready to go.

Owing to the considerable number of IPO activities in the first half of 2006, the volume of IPO financing increased significantly.

**Mainland branches**

In the first half of 2006, Mainland branches' operating profit before loan impairment allowances increased by 5.6% to HK$150 million due mainly to the increase in average loan size. Nevertheless, abundant liquidity and active financing activities in the Mainland resulted in low cost refinancing and hence early repayment by certain large corporate clients. Total advances to customers of our Mainland branches rose only marginally by 0.1% to HK$15,201 million while customer deposits increased by 20.7% to HK$2,803 million.

At the end of June 2006 when two more branches obtained approval to offer RMB business, the Group had a total of 11 Mainland branches and sub-branches permitted to participate in RMB business and 12 branches and sub-branches allowed to conduct derivatives business. All 14 branches and sub-branches are now licensed to provide insurance agency services and the coverage of wealth management products has been extended in the China market. In view of the high demand for investment products in the market, the Group launched commodity-linked deposits in 2006 as an extension to the series of currency-linked deposits offered since 2005. It has also applied for permission to conduct overseas treasury management business to prepare for the implementation of QDII.

## *Treasury*

| HK$'m, except percentage amounts | **Half-year ended 30 June 2006** | Half-year ended 30 June 2005 | Increase/ (decrease) |
|---|---|---|---|
| Net interest income | **2,076** | 568 | +265.5% |
| Other operating income | **719** | 491 | +46.4% |
| Total operating income | **2,795** | 1,059 | +163.9% |
| Operating expenses | **(189)** | (92) | +105.4% |
| Profit before taxation | **2,606** | 967 | +169.5% |

| | **At 30 June 2006** | At 31 December 2005 | Increase/ (decrease) |
|---|---|---|---|
| Segment assets | **455,588** | 426,791 | +6.8% |
| Segment liabilities | **95,407** | 82,381 | +15.8% |

Note: For additional segmental information, see Note 40 to the Financial Statements.

**Results**

In the first half of 2006, Treasury reported a profit before taxation of HK$2,606 million, up 169.5%, largely because of the hefty increase in net interest income.

Net interest income increased substantially by HK$1,508 million or 265.5%. The increase was mainly driven by higher contribution of net free fund and better return on debt securities portfolio.

Other operating income rose by HK$228 million or 46.4%, reflecting an increase in the fair value of foreign exchange swap contracts.

**Investment portfolio diversification to enhance yield**

The Group continued to diversify its investments with mortgage-backed securities, covered bonds and corporate bonds to maximise the return on residual funds. This diversification also helped in reducing concentration risks.

**Development in treasury products and customer trades**

In view of the growing popularity of steady-income investment products, the Group introduced a series of structured deposits linked with interest rates, foreign exchange rates and bullion prices. To further enhance cross-selling activities with retail and corporate banking units, a professional treasury marketing unit providing customised services to local and Mainland customers was set up in late 2005. The team also provided training and consulting support to other marketing teams. This not only enhanced the marketing capability of different business units, but also helped broaden the Group's client base and enrich clients' portfolio. In the first half of 2006, the number of treasury customers increased by 12.3%.

## *Insurance*

| HK$'m, except percentage amounts | **Half-year ended 30 June 2006** | Half-year ended 30 June 2005 | Increase/ (decrease) |
|---|---|---|---|
| Net interest income | **208** | 141 | +47.5% |
| Other operating income | **2,958** | 1,689 | +75.1% |
| Total operating income | **3,166** | 1,830 | +73.0% |
| Net insurance benefits and claims | **(3,060)** | (1,760) | +73.9% |
| Net operating income | **106** | 70 | +51.4% |
| Operating expenses | **(27)** | (23) | +17.4% |
| Profit before taxation | **79** | 47 | +68.1% |

| | **At 30 June 2006** | At 31 December 2005 | Increase/ (decrease) |
|---|---|---|---|
| Segment assets | **12,234** | 9,343 | +30.9% |
| Segment liabilities | **11,176** | 8,365 | +33.6% |

Note: For additional segmental information, see Note 40 to the Financial Statements.

**Results**

The Group's Insurance segment recorded a profit before taxation of HK$79 million, up 68.1% as compared to the first half of 2005, due mainly to the increase in net interest income from deposits and debt securities portfolio. While growth in other operating income was led by the increase in insurance premium income after the successful launch of a number of insurance products in the first half of 2006, it was offset by a corresponding increase in net insurance benefits and claims and the decrease in the fair value of its interest rate instruments and structured notes.

Assets in the Insurance segment grew by 30.9% because of increases in deposits and structured notes. At the same time, this segment's liabilities rose by 33.6% made up mainly of insurance contract liabilities.

**Successful combination with BOC Life**

The Group further enhanced its product manufacturing capability by acquiring a 51% controlling stake in BOC Life in June 2006. To account for the combination, merger accounting method has been applied and comparative figures on this segment were restated. Life insurance policies, investment products linked with life insurance policies and retirement scheme management are now offered through the Group's extensive distribution network. This will significantly enhance the Group's wealth management platform, solidify its client base and diversify the Group's non-interest income.

## Risk Management

### *Banking Group*

**Overview**

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

**Risk Management Governance Structure**

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

The Board of Directors, representing the interests of shareholders, has the ultimate responsibility for risk management. The Board, with the assistance of its committees, has the primary responsibility for the determination of risk management strategies and for ensuring that the Group has an effective risk management system to implement these risk management strategies. The Risk Committee ("RC"), a standing committee established by the Board of Directors, is responsible for approving major risk management policies and procedures and major asset and liability management policies.

The Chief Executive's ("CE") responsibility is to ensure the proper implementation of the policies and procedures and various risk limits in accordance with the risk management strategies set by the Board, and to oversee the effectiveness of managing and controlling risks in the day-to-day management. The Chief Risk Officer ("CRO") and the Chief Financial Officer ("CFO") assist the CE to manage various types of risks. The CRO provides overall leadership, vision and direction for the entire risk management framework and for all other aspects of risks across the group as well as oversees the management of reputation risk, legal and compliance risk, credit risk, market risk and operational risk. The CFO is responsible for the management of strategic risk, interest rate risk and liquidity risk.

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

**Reputation Risk Management**

Reputation risk is the risk that negative publicity regarding the Group's activities, factual or otherwise, may cause a potential decline in the Group's business or lead to costly litigation. Reputation risk is inherent in every aspect of the Group's business operation and covers a wide spectrum of issues.

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

**Legal and Compliance Risk Management**

Legal risk is the risk that unenforceable contracts, lawsuits or adverse judgments may disrupt or otherwise negatively affect the operations or financial condition of the Group. Compliance risk is the risk of legal and regulatory sanctions, which may directly result in financial loss, or affect the reputation of the Group caused by non-compliance to applicable laws, regulations and best industry practices. By establishing and maintaining appropriate policies and guidelines, the CRO, working through the Legal and Compliance Department, is responsible for proactively identifying and managing these risks.

**Strategic Risk Management**

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

**Credit Risk Management**

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract that it has entered into with the Group. Credit risk arises principally from the Group's lending, trade finance and treasury activities.

The Risk Management Department (RMD), under the supervision of CRO, provides centralised management of credit risk within the Group. Credit policies and procedures are formulated by RMD and are approved by the RC and the Board of Directors. Such policies include setting controls over the maximum level of the Group's exposure to customers and customer groups and other risk concentrations in selected market sectors, industries and products. These credit policies and procedures are regularly updated and serve as guidance to business units as to the risk appetite of the Group from time to time.

RMD also undertakes independent review and objective assessment of credit facilities originated by business units. Different credit approval and control procedures are adopted according to the level of risk associated with the customer or transaction. Currently, a credit scoring system is used to process retail credit transactions, including residential mortgage loans, personal loans and credit cards. The Credit Risk Assessment Committee comprising experts from credit and other functions of the Group is responsible for making an independent assessment of all credit facilities which require the approval of Deputy Chief Executives or above.

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

**Market Risk Management**

Market risk is the risk associated with the movements of foreign exchange rates, interest rates or equity and commodity prices on the earnings of the Group. The Group's market risk arises from customer-related business and from position taking. Trading positions are subject to daily marked-to-market valuation. Market risk is managed within the risk limits approved by the RC. The overall risk limits are divided into sub-limits by reference to different risk factors, including interest rate, foreign exchange rate, commodity price and equity price.

The Market Risk Division in RMD is responsible for the daily oversight of the Group's market risk. The Division ensures that the overall and individual market risk positions are within the Group's risk tolerance.

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

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

| HK$'m | **At 30 June 2006** | **Minimum for the first half of 2006** | **Maximum for the first half of 2006** | **Average for the first half of 2006** |
|---|---|---|---|---|
| VAR for all market risk | **2.9** | **1.7** | **5.0** | **3.4** |
| VAR for foreign exchange risk | **3.7** | **1.3** | **5.3** | **3.3** |
| VAR for interest rate risk | **1.5** | **1.0** | **3.0** | **1.9** |
| VAR for equity risk | **0.6** | **0.1** | **0.8** | **0.3** |

| HK$'m | At 30 June 2005 | Minimum for the first half of 2005 | Maximum for the first half of 2005 | Average for the first half of 2005 |
|---|---|---|---|---|
| VAR for all market risk | 2.8 | 1.7 | 4.7 | 2.9 |
| VAR for foreign exchange risk | 1.9 | 1.2 | 4.0 | 2.1 |
| VAR for interest rate risk | 2.1 | 1.6 | 3.7 | 2.5 |
| VAR for equity risk | 0.1 | 0.0 | 0.5 | 0.1 |

For the first half of 2006, the average daily revenue of BOCHK earned from market risk-related trading activities was HK$2.6 million (first half of 2005: HK$2.2 million). The standard deviation of these daily trading revenues was HK$1.7 million (first half of 2005: HK$2.1 million).

RMD is also responsible for monitoring foreign exchange exposure and related stop-loss limits on a day-to-day basis as well as the credit risk exposure arising from foreign exchange transactions.

**Interest Rate Risk Management**

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

| | | |
|---|---|---|
| repricing risk | – | mismatches in the maturity or repricing periods of assets and liabilities |
| basis risk | – | different pricing basis for different transactions so that yield on assets and cost of liabilities may change by different amounts within the same repricing period |

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

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

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

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

Stress tests on repricing risk and basis risk are conducted regularly. ALCO monitors the results of stress tests against limits and decides whether remedial action should be taken.

**Liquidity Risk Management**

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

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

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

**Operational Risk Management**

Operational risk relates to the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events. An Operational Risk Management Division is set up within RMD to oversee the entire operational risk management framework of BOCHK.

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

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

**Capital Management**

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

**Stress Testing**

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

### *Insurance Group*

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

**Insurance Risk**

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

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

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

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

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

**Interest Rate Risk**

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

**Credit Risk**

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

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

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

The management of BOC Life directs its reinsurance placement policy and assesses the creditworthiness of all re-insurers and intermediaries by reviewing credit grades provided by rating agencies and other publicly available financial information.