CHIEF EXECUTIVE'S REPORT

The operating environment in the past year was as challenging as any we had seen in decades. The negative impact of the global financial turmoil was felt in virtually all sectors of the global economy, particularly in the latter half of the year. We witnessed a widespread credit crunch and the liquidity problems encountered by a large number of major players in the financial, commercial and industrial sectors. Back home, the financial sector did not escape the crisis while the manufacturing and export sectors suffered from diminished external demand. This in turn affected the job market and income level, with the retailing sector hard hit. Pessimistic sentiment prevailed in most investment markets.

Key Initiatives

During this unprecedented crisis, our overall focus has been to safeguard the Group's financial strength and enhance its competitiveness. Throughout the year, we took various initiatives in the areas of capital preservation, liquidity management, risk control and cost containment, in order to fortify our foundation.

- We adopted decisive measures to enhance our capital base and optimise our capital structure with the support of our parent bank, BOC, from which we obtained two subordinated loans.
- We minimised the risk exposure of our balance sheet by proactively adjusting our asset allocation.
- We exercised rigorous control in liquidity management amid extremely volatile market conditions.
- We continuously reassessed the risk exposure of our loan portfolio and adjusted our lending strategies in a swift and prudent manner.
- We took prompt action to contain our costs in view of the weakening operating environment.

Business Highlights

In response to rapid market changes and amid economic uncertainties, we refined our business strategy, capitalising on our core strengths and continuing to grow our franchise under tough environment. This geared us towards the steady performance of our traditional business segments in what was a turbulent year during 2008.

- Net interest income – a key part of the Group's core operating income – continued to rise despite pressure from falling interest rates.
- Our lending business scored higher growth than the market in 2008. Total loans and advances registered double-digit growth.
- Our loan-to-deposit ratio rose steadily while loan quality remained satisfactory. The Group's deposit mix also improved on a strong deposit base.
- Fee income from traditional banking services grew by a healthy margin, reflecting our strength in these core business areas.
- We maintained our market leadership in residential mortgage lending, loan syndication and RMB-related banking in Hong Kong respectively.
- The Group's Mainland business registered growth in operating income. Our loan quality in the Mainland also remained good.
- Good progress was made in deepening our collaboration with BOC in various business fields.

Financial Performance

The Group's financial performance in 2008 was hurt by the increasingly difficult market conditions.

Operating income decreased by 6.3% to HK$25,526 million. While there was an increase of 3.9% in net interest income, it was more than offset by the 17.5% reduction in fees and commission income as well as the operating loss incurred by the Group's insurance business. With the 12.8% rise in operating expenses, operating profit before impairment allowances was down by 14.0% to HK$16,755 million. The Group's profit attributable to shareholders decreased by 78.4% year-on-year to HK$3,343 million. This was caused mainly by the increase in impairment charges on securities investments amounting to HK$11,900 million. Earnings per share were HK$0.3162, representing a drop of 78.4%.

Return on total average assets (ROA) and return on average shareholders' funds (ROE) were 0.27% and 3.81%

respectively, versus 1.53% and 17.40% respectively for 2007. ROA and ROE before impairment allowances were 1.52% and 19.09% respectively.

Net interest income increased to HK$20,157 million as the Group's average interest-earning assets grew by 7.3% to HK$1,006,440 million. This growth was achieved by the expansion of our lending business and the increase in average deposits from customers, banks and financial institutions. We witnessed further growth in higher yielding loans. At the same time, we were able to adjust the pricing of new loan facilities to reflect the tightening of credit in the market. Net interest margin (NIM) was down by 0.07 percentage point to 2.0% in 2008, due mainly to decline in the contribution from net free fund as market interest rates dropped significantly. The substantial increase in RMB deposits from the participating banks also contributed to 0.04 percentage point decline in NIM given the Group's role as the RMB Clearing Bank in Hong Kong. Should this factor be excluded, the adjusted NIM would have been 2.07%, down by 0.03 percentage point.

The performance of our core lending business remained sound in 2008. Its growth slowed down somewhat in the second half as we opted for a more prudent lending policy in view of the increasing uncertainty in the credit market. Total loans and advances to customers rose by a healthy 11.5% to HK$460,447 million. This was due to the across-the-board growth of loans, of which corporate loans grew by 13.7%, residential property mortgage by 9.1% and card advances by 13.7%. Loans for use outside Hong Kong registered a growth of 19.5% with Mainland lending up by 5.6%. The Group's loan-to-deposit ratio at end-2008 was up 5.08 percentage points to 56.74% as the growth of loans outpaced that of deposits.

The Group's net fees and commission income declined by 17.5% to HK$5,179 million largely attributable to the fall in investment-related fee income. The investment environment turned sluggish in the aftermath of the global financial crisis. As customers mostly steered clear of investment products, the investment and insurance fee income decreased by 34.3% to HK$2,964 million.

On the positive side, we recorded a growth of 16% in the fee income from our traditional banking business. Loan commission grew markedly by 47.8% to HK$513 million, benefiting from our expanded loan portfolio and the successful launch of BOC Group's Asia Pacific Loan Syndicated Centre. RMB-related business performed exceptionally well by recording an income growth of 62.8%. Our credit card business, bills service and currency exchange business also posted encouraging performance, growing their fee income by 18.8%, 16.2% and 10.9% respectively. Concurrently, we witnessed good progress in new business areas such as custody services and cash management, which have made new contribution to the Group's fee income.

Thanks to the strong performance in the first half of 2008, we achieved a year-on-year growth in net trading income of 88.9% to HK$1,914 million. This remarkable growth was driven by the 126.1% surge in the trading income from currency exchange and foreign exchange products. We captured the opportunity by launching those products to meet the higher demand from customers for currency-related products in the volatile market and the anticipated appreciation of the RMB. We also saw a significant improvement in the net trading income from mark-to-market on foreign exchange swap contracts.

As for BOC Life, its insurance and investment income declined by HK$1,497 million due to the weak performance of its investment assets and the lower business volume in the second half of the year.

In view of the unstable market conditions, we reassessed our impairment charges and increased our provisions accordingly. For the Group's US mortgage-backed securities and other debt securities, an amount of HK$9,170 million was provided. A total of HK$2,730 million was provided for the Group's investment in the shares of Bank of East Asia.

Amid the aggravating economic conditions, the Group was highly prudent in managing its operating expenses. In the second half of 2008, we even managed to trim down our core operating expenses by 4.3% as compared with the first half. For the whole year, we outperformed the market by containing the increase of our core operating expenses to 2.9% and the corresponding cost-to-income ratio by 2.83 percentage points to 31.35%. However, it was only due to the extraordinary expenses mainly in connection with the Lehman Brothers Mini-bonds issue totaling HK$769 million that our total operating expenses rose by 12.8% while our cost-to-income ratio rose by 5.84 percentage points to 34.36%.

The Group's financial position remained stable. At the end of 2008, our total assets stood at HK$1,147,244 million, representing an increase of 7.5% versus end-2007, which was mainly because of the expansion of our loan portfolio. The Group's classified or impaired loan ratio increased by a negligible margin of 0.02 percentage point to 0.46% – far below the market average of 1.24%.

To better prepare ourselves for the uncertainty in the financial market, we further strengthened our capital position by two subordinated loans from BOC. The first loan of 660 million Euros was made in June while the second loan of US$2,500 million, in December. The Group's consolidated capital adequacy ratio was therefore up 3.09 percentage points to 16.17% at the end of 2008, with tier-one ratio at 10.86%. Reflecting our healthy liquidity position, the Group's average liquidity ratio stood at 41.74%, versus 50.92% in 2007.

Business Review

Personal Banking

The Group's Personal Banking business was subject to declining interest rates and the adverse change in market conditions in the second half of the year. Its operating income was HK$10,690 million, down 24%. Net interest income and other operating income fell by 20.1% and 29.5% respectively. Profit before taxation was HK$4,892 million, down 39.8%.

Over the year, we maintained growth in our traditionally strong segments. We also took various initiatives to reinforce our capabilities and strengthen our competitiveness.

We succeeded in driving the growth of the residential property mortgage business while consistently maintaining our market leadership. Through marketing promotion schemes and service enhancement, we outperformed the market by growing our mortgage loans by 9.1% year-on-year, higher than the market average of 5.1%. Towards the latter half of the year, we strengthened our risk assessment and control on the mortgage business. The quality of mortgage loans remained excellent with the delinquency and rescheduled loan ratio falling further to 0.05%, versus a market average of 0.19%.

We sustained the growth momentum of our credit card business. Card advances and card issuance increased by 13.7% and 2.8% respectively whereas cardholder spending and merchant acquiring volume rose by 12.7% and 19.9% respectively. We took advantage of new business opportunities, such as the Beijing Olympics, to launch a series of new cards and expand our card-related service. In collaboration with China UnionPay (CUP), the "BOC CUP Dual Currency Credit Card" was issued in December 2008. The asset quality of our card business remained good with the charge-off ratio standing well below the market average at 2.22%.

We maintained our market leadership in the RMB-related banking business in Hong Kong. We commanded the largest share of RMB deposits, which surged by 58.5% in 2008. We led the market in the RMB credit card business, growing our card issuance, cardholder spending and merchant acquiring volume by 24.6%, 49.8% and 60.5% respectively. To better serve our customers, our RMB cash withdrawal service has been extended to all of our ATMs located at MTR stations. During the year, we acted as the joint lead manager and bookrunner as well as placing bank for RMB bonds issued in Hong Kong by three major Mainland banks to a total value of 9 billion yuan.

Capitalising on our strong franchise, we continued to expand our high net-worth customer base and reinforce our status as a professional wealth management service provider. We have been working closely with BOC in preparation for the offering of cross-border wealth management services in the Mainland. This service will be offered through designated branches of BOC in the Mainland in the first half of 2009. As at the end of 2008, the number of wealth management customers increased by a very encouraging 21.5% from a year ago.

To enhance operational efficiency, we continued to consolidate our service platforms for investment, insurance and wealth management services. We also optimised our distribution channels. To provide more efficient and professional service to different customers, we added new wealth management centres and mortgage advice centres to our network in Hong Kong. Our e-banking channels have also been further upgraded to facilitate transactions with customers.

Corporate Banking

Throughout 2008, Corporate Banking basically maintained steady growth. It attained an increase of 7.1% in operating income to HK$8,211 million with the rise in both net interest income and other operating income. Its profit before taxation was HK$5,524 million, down 15.4% mainly due to the increase in net charge of loan impairment allowance.

Corporate Banking made considerable progress in growing both its core and new business segments as well as in reinforcing its service platform for corporate clients.

We strengthened our leading position and enlarged our shares in two syndicated loan markets, namely, the "Hong Kong-Macau" and the "Mainland-Hong Kong-Macau" regions. As reported in our Interim Report, the Group was appointed in January 2008 as BOC Group's Asia-Pacific Syndicated Loan Centre. After this appointment, we immediately proceeded to extend our reach to the Asia-Pacific region and succeeded in becoming the sole arranger for two major Australian enterprises, which helped to enhance our market status.

We continued to upgrade our business platform. Through the enhancement of product offerings, services and channels, we recorded a steady year-on-year rise in SME loans and received awards for supporting the development of SMEs in Hong Kong. Our trade finance business expanded through product innovation and the streamlining of credit approval. Strong upsurge was recorded in the first half of the year but it slowed down in the fourth quarter as the performance of Hong Kong's external trade weakened. The outstanding balance of trade finance showed a slight increase of 1.2% against end-2007 but there was still a strong increase of 32.0% in the volume of trade bills settlement.

We forged ahead with the development of new businesses with encouraging results. Our cross-border cash management business expanded as we continued to enhance our service for major Mainland enterprises. Locally we broadened our cash management customer base through product innovation and refinement. Meanwhile, our custody business advanced with the expansion of the number of customers. In 2008, we became the custodian for a number of locally-listed or offshore-incorporated investment funds. The Group was appointed by a joint-venture investment bank in the Mainland as the foreign custodian for its first QDII product, which was also the first broker-type QDII product approved in the Mainland. By end-2008, total assets under the Group's custody was HK$200 billion.

During the year we enhanced the Group's financial services for corporate customers by setting up a commercial wealth management team. This team of professionals is responsible for customising financial management strategy and conducting regular reviews to help customers in maximising their wealth potential and managing risks.

As the economic downturn lingered on, the Group took a number of proactive measures to contain its risk exposure to corporates. A special working group was established and tasked with evaluating the risk exposure of the Group's loan portfolio. Comprehensive and frequent re-assessment of credit risk and stress tests on customers from key business segments were conducted. In accordance with the market conditions, we adjusted our loan pricing strategy after taking into full account the liquidity and risk factors.

Mainland Business

The Group's Mainland business continued to make advances and attained satisfactory growth in 2008. Total advances to customers grew by 5.6%, of which RMB loans surged by 12.6%. Customer deposits up by 72.5%. Total operating income increased by 15.9% to HK$990 million, which was driven primarily by the growth of net interest income as well as net fees and commission income. It was, however, partially offset by the foreign exchange loss resulting from the revaluation of NCB (China)'s HKD capital against the appreciated RMB. Operating profit before impairment allowances fell by 3.1% year-on-year. Should the revaluation factor be excluded, operating profit before impairment allowances would have increased by 23.3%. Our asset quality in the Mainland remained good, with the classified loan ratio standing at 0.88%, increasing by 0.20 percentage point mainly due to the downgrade of certain large accounts.

In 2008, we stepped up our effort in extending cross-border financial services to both personal and corporate customers. New deposits, mortgage and other lending products were rolled out with good response. New branches and sub-branches were opened in targeted locations, as a result of which our network in the Mainland comprised 18 branches and sub-branches by the end of 2008. The opening of more branches is underway.

Treasury

The Treasury segment registered a 32.6% growth in operating income in 2008. This was driven by the rise in both net interest income and other operating income. Operating profit before impairment allowances grew by 32.6% to HK$7,226 million. However, the segment recorded a loss before taxation of HK$1,944 million mainly due to the substantial increase in net charge of impairment allowance on securities investments.

As the global financial crisis unfolded during the year, we worked with relentless efforts on portfolio management so as to safeguard our investment portfolio and minimise potential loss. Fund safety and liquidity are our primary considerations in formulating investment strategies. As a result, the Group's exposure to US non-agency RMBS dropped by 51.3% to HK$19.3 billion at end-2008, of which sub-prime-related investments decreased to HK$1.05 billion. Despite the market volatility, there was no default in the RMBS portfolio and we continued to receive interest and repayments on those mortgage-backed securities. Our exposure was also reduced through disposal. We refined our investment strategy to give more weight to high-quality debt securities, including sovereign-related securities. By end-2008, the proportion of such investments in the Group's portfolio grew to 25%, versus 6% a year ago.

The Group succeeded in growing its traditional businesses and further improving its product manufacturing capability. Through the effective promotion of commodity and currency-related treasury products, we recorded robust growth in related income. At the same time, we expanded our product offerings by launching new investment products under our own brand. In view of the global financial turmoil, we promptly conducted a comprehensive evaluation of all products under distribution and reviewed our internal regulations, risk control measures and compliance procedures.

Insurance

The Group's Insurance segment recorded a fall of 32.5% to HK$6,625 million in operating income. Net interest income was up 42.4% to HK$1,122 million and other operating income was down 39.1% to HK$5,503 million, caused by the weak performance of investment assets and the decline in premium income. A loss before taxation of HK$1,231 million was registered.

We moved forward with our business strategy by introducing a broader range of products to serve customers' needs. Large-scale promotion and marketing campaigns were staged during the year to boost sales, reinforce our brand image and grow our market share. At the same time, we continued to develop a multi-channel platform and expand our sales force.

Outlook

Given the external-oriented nature of the Hong Kong economy, the economic outlook in Hong Kong for 2009 crucially hinges on the development in the global economy. As a high degree of uncertainty still hovers over the global financial market, the operating environment is expected to remain tough in the coming year and perhaps well beyond. We have seen contractions in our GDP growth, rising unemployment and negative wealth effects. However, we in Hong Kong are in a better position as we are blessed with the unswerving support of the Mainland, which maintains relatively stable economic conditions and financial strength. The RMB 4 trillion-yuan stimulus plan announced by the PRC Central Government in November 2008 and subsequent policies and measures to protect and stimulate the Chinese economy are expected to give rise to new opportunities for the Hong Kong economy and its financial services sector.

On the management side, to fend off any existing and unseen difficulties, we will continue to strengthen risk management and internal control. We will stay highly alert and proactive in responding to market changes and in anticipating the development of the situation. Underpinned by a solid capital base and liquidity position, we are now better equipped to weather the current financial turmoil and provided with greater flexibility in meeting our development needs. However, in driving growth and developing new business, we will remain stringent in managing our costs.

On the business front, we should leverage our fundamental strengths to enhance the competitiveness of our core business. We will build on our strong franchise in traditional banking businesses. By attaining a more balanced loan portfolio, a better deposit mix and a stronger customer base, we seek to improve the overall business structure. We will also strive to boost our operational efficiency. To cater to the diverse needs of customers, we will align our strategy with the changing environment and provide quality banking and financial services that can also address customers' prime concerns such as stability, safety and liquidity.

While ensuring our market leadership in Hong Kong's existing RMB banking business, we expect the imminent launch of the RMB trade settlement pilot scheme that allows the use of RMB as a currency for trade settlement between Guangdong Province, Yangtze River Delta and HKSAR will open a major window of opportunities for expanding the Group's RMB banking business. Meanwhile, having launched the first dual currency (HKD-RMB) credit card jointly with China UnionPay in Hong Kong, we are now in an advantageous position to expand our credit card business in both Hong Kong and the Mainland. Furthermore, we will continue to expand our cross-border financial services to serve both corporate and personal customers.

We will continue to collaborate with BOC to capture emerging business opportunities in China and provide more wide-ranging cross-border banking services to Mainland enterprises intending to expand outside China. As BOC Group's Asia-Pacific Syndicated Loan Centre, we will explore new business in the region so as to expand the territorial coverage of our loan syndication business. Riding on our experience and capabilities, we will act as an effective product manufacturing agent and a service support centre for BOC in the Asia-Pacific region. In anticipation of growing demand in the Mainland, we have already established a joint venture with BOC to provide bank card related services and support in this huge market.

In concluding, it is apparent that the current economic slowdown is unlikely to end soon. However, backed by the strong foundations we have systematically built for the Group in recent years and with the continued guidance of the Board as well as the support of shareholders, customers and colleagues, I truly believe that we will come through in better shape in the days ahead.

HE Guangbei
Vice Chairman & Chief Executive

Hong Kong, 24 March 2009