CHIEF EXECUTIVE'S REPORT

The operating environment for the banking and financial services sector remained highly challenging in early 2009 as many uncertainties stemming from last year's unprecedented global financial turmoil still existed. Loan demand remained weak. Merchandise trade was shrinking. Unemployment kept on rising and private consumption turned sluggish. The situation, however, was beginning to stabilise in the second quarter with the emergence of some positive developments, including the influx of capital and the return of investors' confidence in the stock and property markets.

Fully alert to these changes in the economy and market sentiments, we lost no time in refining our business strategy accordingly and adopted a more proactive approach in driving business growth. While continuing to maintain our capital strength, liquidity management, risk control and cost containment, we took initiatives to seize rising opportunities to gear towards the growth of the Group's traditional core business segments. By riding on our solid foundation and strong franchise, we recorded significant improvement in operating performance versus the second half of last year and achieved most of our business targets under the difficult market conditions.

Overall speaking, we have regained our growth momentum after a very trying 2008. Not only had we to a large extent recovered the lost ground experienced last year, but also enhanced our business capabilities to better position the Group for the upcoming recovery and a more sustainable development in the time ahead.

Business Highlights and Initiatives

The following summary highlights our key business results we delivered and major initiatives we took in the first half of 2009:

- Led by the growth of core businesses, operating income and operating profit improved considerably from the second half of 2008. These, together with a substantial drop in the net charge of impairment allowances, led to a reversal of profit attributable to shareholders.

- Our lending business recorded a healthy growth whereas the overall market declined amid the deepening economic downturn. We therefore gained a larger market share in lending business and increased our loan commissions by a significant margin.

- We continued to maintain leading positions in corporate lending, loan syndication, residential mortgage and RMB-related banking services in the Hong Kong market.

- Our stock brokerage business was able to benefit tremendously from the surge in stock transactions in recent months as supported by the Group's enhanced service infrastructure and other business initiatives.

- Through collaboration with BOC and in our role as BOC's Asia-Pacific Syndicated Loan Centre, we made good progress in growing our loan syndication business in the region and boosting related income.

- Our loan quality has proved to be excellent with lower classified or impaired loan ratio in an adverse market environment. We thus witnessed a net reversal of loan impairment allowances in the first half.

- By adjusting our asset allocation in a proactive and decisive manner, we reduced the risk exposure of our investment portfolio. On the back of improved sentiment in the capital markets, impairment charge on securities investments was impressively lower.

- Operating expenses were under rigorous control in view of the tough operating environment, keeping the cost-to-income ratio at a low level by industry standard.

- With strengthened capital base and liquidity management, we have fortified our foundation for any unpredictable and unfavourable changes in the highly volatile market.

Financial Performance

In the first six months of 2009, the Group's operating income was HK$13,028 million, down 7.2% year-on-year but it represented a marked improvement of 13.4% from the second half of 2008. Operating profit before impairment allowances was HK$8,834 million, down 11.2% year-on-year but again was an increase of 29.8% versus the second half of 2008.

For the first half of 2009, profit attributable to the Company's shareholders was HK$6,691 million, down by a moderate 5.6% year-on-year due mainly to a drop in net interest income caused by the narrowing of net interest margin. However, against the net loss of HK$3,745 million in the second half of 2008, it represented a major improvement which can be attributed to the increase in operating income as well as the decrease in impairment charges on securities investment.

Return on average total assets (ROA) and return on average shareholders' funds (ROE) were 1.23% and 15.13% respectively, versus 1.32% and 15.09% respectively for the same period in 2008.

Net interest income decreased by 11.0% year-on-year to HK$8,929 million as net interest margin narrowed by 27 basis points to 1.76%. This decrease was partially offset by the growth of 3.5% in average interest-earning assets which reached HK$1,023.45 billion by end-June 2009. Net interest margin (NIM) narrowed because of the decline in the contribution from net free funds in the low-interest environment and also lower interest spread.

Net fees and commission income grew by 1.7% year-on-year to HK$2,947 million. Compared to the second half of 2008, it soared by a very robust 29.3%. The key driver of this growth was stock brokerage. Capitalising on the rebound of the local stock market, we grew our stock brokerage fee income by 26.1% to HK$1,625 million year-on-year. The Group's enhanced service platform played a major role in this growth. Meanwhile, loan commission income grew by 51.3% when compared to first half of 2008.

Net trading income fell by 28.1% to HK$889 million year-on-year due to the reduction in net trading income from foreign exchange and related products, interest rate instruments and equity instruments because of lower demand in the economic downturn. Compared to the second half of 2008, however, we experienced a growth of 31.3%, resulting mainly from a mark-to-market gain on interest rate swap contracts.

On the expenditure side, we continued to exercise a high degree of prudence in managing costs. During the period under review, total operating expenses increased by 2.6% to HK$4,194 million year-on-year but decreased by 10.4% as compared with the second half of last year. If the expenses mainly related to Lehman Brothers Minibonds was not included, our total operating expenses would have decreased by 2.8% year-on-year because of savings in staff costs. The Group's cost-to-income ratio stood at the low level of 32.19%, versus 29.12% a year ago. But if the expenses mainly related to Lehman Brothers Minibonds was excluded, cost-to-income ratio would have become 30.49%.

As global capital markets showed signs of stabilising in the second quarter, the Group's net charge of impairment allowances on securities investment dropped by 45.6% year-on-year and 88.0% half-on-half to HK$1,168 million. For the same period, the Group recorded a net reversal of loan impairment allowances of HK$60 million as compared with a net charge of HK$71 million in the first half of 2008.

Despite sluggish market demand, our strenuous effort and initiatives in strengthening our core lending business paid off. Against the market average of a negative 2.5% for the period under review, we recorded a growth of 3.3% to HK$475,564 million in total loans and advances to customers, of which corporate loans increased by 4.5% and residential mortgage loans by 1.6%. As mentioned above, we were also benefitted by our designation as BOC's Regional Syndicated Loan Centre to expand our syndicated loan business beyond Hong Kong and the Mainland. The Group's loan-to-deposit ratio was 57.66%, versus 56.74% at the end-2008.

As at end-June 2009, the Group's total assets reached HK$1,146.15 billion. Due to our continuous efforts to manage risks rigorously and effectively, our loan quality remained solid. The Group's classified or impaired loan ratio for the first half of 2009 was 0.37%, versus 0.46% as at end-2008.

Our capital and liquidity positions remained strong. Consolidated capital adequacy ratio (CAR) as at end-June 2009 was 16.10%, down from 16.17% at the end-2008. The average liquidity ratio stayed healthy at 39.70%, compared to 42.47% in the first half of 2008.

Business Review

Our operating performance in the first six months speaks for our prowess in growing and developing our business even under adverse market conditions.

Personal banking

The Group's Personal Banking segment registered an operating income of HK$5,067 million and a profit before taxation of HK$2,216 million, down 13.6% and 25.3% year-on-year respectively. The decreases were caused mainly by lower net interest income and other operating income. Net interest income dropped as deposit spread narrowed against the backdrop of local deposit interest rates close to zero. The reduction in the sales of open-end funds and structured notes as well as foreign exchange activities led to the fall in other operating income.

As the operating environment began to improve after the first quarter, we took prompt initiatives to further reinforce our market position. Through effective marketing efforts, product innovation and cooperation with developers, we regained our growth momentum in residential property mortgage and maintained our market position. During the interim period, the Group's outstanding mortgage loans grew by 1.6% versus end-December 2008. We remained highly cautious over the quality of mortgage loans and exercised rigorous risk assessment and control. As a result, the delinquency and rescheduled loan ratio still stood at a low 0.07%.

Our stock brokerage business experienced a strong rebound as the local stock market became more active during the period. Our service platform for stock trading, especially the e-channel, that has been drastically enhanced in the recent past allowed us to benefit from this upturn and realised transaction growth. Our stock brokerage volume rose by 7.9% year-on-year and 52.8% versus the second half of 2008 and our market share reached a record high.

We grew our wealth management segment through service enhancement and customisation. We also strove to attract new wealth management customers with a host of promotional offers. By collaborating with BOC, we expanded our cross-border wealth management services for customers. In the first six months of this year, the total number of wealth management customers and the volume of assets under our management increased by 3.5% and 15.7% respectively.

Despite the impact of economic downturn on customers' spending, we managed to sustain the growth of the credit card business. Card issuance increased by 10.1% when compared to end-2008. Cardholder spending and merchant acquiring volume rose by 1.4% and 5.8% respectively when compared to same period of last year. As a reflection of the increased demand generated from cross-border travelling, customers' response to the "BOC-CUP (China UnionPay) Dual Currency Credit Card" launched in December 2008 was overwhelming with the number of cards issued exceeding 200,000 by end-June 2009. The loan quality of card advances remained excellent with the annualised charge-off ratio standing at 3.14%.

We enjoyed a leading position in RMB banking business in the Hong Kong market. Our focus this year is on RMB integrated services including "RMB Remittance Express" and "RMB Exchange Express". To grow our market share in RMB deposits, promotional offers were introduced. As a result, the market share of RMB deposits increased in the first six months. Our RMB credit card business witnessed robust growth and led the field in most areas.

In the period under review, RMB card issuance surged by 96.4% from end-2008 while merchant acquiring volume and cardholder spending grew by 47.0% and 90.8% respectively when compare to same period of last year.

To facilitate long-term growth, we continued to upgrade our service infrastructure, especially the e-banking channels. In the first half of this year, the number of personal e-banking customers and stock transactions conducted through the e-channels rose by 3.1% and 10.8% respectively.

Corporate Banking

The Group's Corporate Banking business experienced substantial growth versus the second half of last year. Operating income saw a moderate decrease of 6.4% year-on-year to HK$3,841 million due mainly to a drop in net interest income but other operating income increased as a result of higher fee income from loans. Profit before taxation dropped only slightly by 0.9% to HK$2,935 million.

Leveraging our internal strengths and close relationship with BOC, we succeeded in delivering solid results in our Corporate Banking segment.

Despite the weak demand for loans in the economic downturn, we grew our corporate loan portfolio by 4.5% and captured a larger market share in the first six months. We remained the top mandated arranger in the Hong Kong-Macau syndicated loan market. In our role as BOC's Asia-Pacific Syndicated Loan Centre, we have been actively expanding our business in the region. The growth of our syndicated loan portfolio contributed to the rise in loan commission income.

We continued to expand our SME business, which is the backbone of the Hong Kong economy. In support of the HKSAR Government's initiatives to help SMEs in the recession, we were active in promoting both the "SME Loan Guarantee Scheme" and "Special Loan Guarantee Scheme". We also introduced a one-stop cash management solution for corporate customers, including SMEs. The quality and range of services targeting SMEs won us the "SME's Best Partner Award" for the second year in a row.

During the period under review, we deepened our collaboration with BOC and introduced a host of cross-border trade finance products. Although the trade finance business in general suffered from sluggish world trade in the beginning of this year, our hard work and innovative services enabled us to see a rebound in the second quarter. As Hong Kong's RMB clearing bank, we signed the "Clearing Agreement in Relation to Renminbi Business" with the People's Bank of China on 4 July and the cross-border RMB trade settlement clearing service was officially launched on 6 July 2009.

Much progress was made in developing our cash management business through service enhancement. In March this year we were designated as the USD settlement bank in Hong Kong for the Real Time Gross Settlement System linkage between Hong Kong and the Mainland, and we have been actively promoting this new service for customers. In June we launched an express collection service for corporate clients, which helped to capture a greater transaction volume and encourage them to use their accounts at the Group as their major operating accounts.

Mainland Business

The Group's Mainland business was up by 15.1% to HK$466 million in operating income. Profit before taxation was HK$308 million, up 30.5%, due mainly to lower exchange loss of capital funds and higher recoveries. Customer deposits increased by 6.3%, of which RMB deposits were up 10.5%. Total advances to customers fell by 9.9%. The loan quality remained good, with the classified loan ratio standing at 0.48% versus 0.88% at end-2008.

During the interim period, we continued to expand our branch network in the Mainland which now comprises 22 branches and sub-branches. We also expanded our range of cross-border services for both personal and corporate customers, and introduced diversified deposit and mortgage products. With the formation of strategic alliances with a number of insurance companies, we are able to offer various types of general and life insurance products to meet the increasingly sophisticated needs of customers.

Treasury

The Group's Treasury recorded an operating income of HK$3,746 million, down 14.7%, of which net interest income was down 15.7% to HK$2,914 million. Operating profit before taxation was up 20.7% to HK$2,184 million, caused mainly by the reduction in net charge of impairment allowances on securities investment. Operating profit before impairment allowances fell by 15.3% to HK$3,352 million.

This year the Group continued to pursue a prudent strategy for protecting its investment portfolio while remaining flexible to maximise investment gains. At the beginning of the year, in view of market volatility, the Group's investments were mostly concentrated on short-term government bills. As the market began to stabilise in the second quarter, we switched more investments to high-quality fixed-rate debt securities of government-related and government-guaranteed agencies while extending the maturity of interbank placements, thus achieving relatively steady return.

We adopted a prudent and proactive approach in asset allocation. While the Group aimed to reduce the overall credit risk of its investment portfolio, the carrying value of the Group's exposure to US non-agency RMBS decreased by 23.1% to HK$14.9 billion during the first half of 2009 due to disposal and consistent repayment.

As regards treasury investment products, our focus in these six months was on traditional products related to foreign exchange and precious metals. Because interest rates were low, corporate customers were offered foreign-exchange and interest-rate linked hedging products.

With the setting up of the Treasury Product Committee towards the end of last year, the Group is now in a stronger position to manage its treasury products.

Insurance

The Group's insurance business had a decline in operating income of 67.5% to HK$1,135 million. The decline was mainly caused by lower premium income and an increase in mark-to-market loss of debt securities investments. After accounting for the decrease in net insurance benefits and claims, we recorded a profit before taxation of HK$155 million for the interim period versus a loss of HK$178 million in the first half of 2008.

In terms of product offerings, the focus of this year has been to extend our range to cover more regular-premium products. These products received encouraging response from customers and boosted related premium income by over 50% year-on-year. At the same time, we introduced some new single-premium products to meet the needs of customers.

On 6 July this year, the Company injected HK$765 million into BOC Life so that the latter now has a stronger capital base for business development and expansion.

Outlook

While at this stage it is still premature to speak of a full recovery of the global economy, we should nevertheless be encouraged by recent market signs that point to the gradual stabilisation of the overall economic situation. As the turbulence and its knocks-on effects begin to subside, more business opportunities would be likely to arise in the near future. Given the fact that the Group's foundations have remained sound and solid after the global financial turmoil, the Group is now in a better position than a year ago to focus on the growth of business and return. Having said that, we will be highly vigilant over any potential pitfalls in the market and we are more rigorous in safeguarding our financial strength, as well as in managing risks and costs. To strike a balance between business growth and risk control, we will pursue a prudent yet flexible development strategy in an environment of change, challenge and competition.

Meanwhile, the three banks of the Group (BOCHK, Nanyang and Chiyu) and the other thirteen banks in Hong Kong reached an agreement with the regulatory authorities on 22 July in relation to the repurchase of Lehman Brothers Minibonds. With a view to maintaining harmony amongst all sectors in the society and safeguarding the interests of the public in Hong Kong, the Distributing Banks of Minibonds, without admission of liability, took a proactive approach to offer the affected Minibonds customers the Repurchase Scheme. This is a comprehensive and reasonable solution for the Minibonds issue that will help the banking industry and the society of Hong Kong as a whole to move forward and seize the opportunities that may arise in the economic recovery.

Our performance in the first half of this year reflects the progress we have made in regaining our growth momentum and earning power. In the remainder of the year and beyond, we will strive to grow our business particularly from core segments, improve our profitability, and further reinforce our market position in Hong Kong, the Mainland and the region.

Capitalising on our fundamental strengths, we will continue to focus on our traditionally strong business segments and enhance our competitiveness in these areas. We will align our strategies in product offering with the changing market situation and provide quality services that can cater to the diverse needs of our customers. Our extensive distribution channels, enhanced business platform, product development capabilities and, above all, our customer relationship, will give us an edge in growing our core business segments, including lending, deposit-taking and investment agency services, while at the same time allowing us to drive the growth of insurance and credit card businesses.

Further expanding the Group's service scope is one of our priorities. We will continue to reinforce our business platforms and grow our newly developed business areas, including cash management and custody. To promote a more sustainable development in the long run, we will explore new business areas with good potentials and, where necessary, make appropriate investment in related service infrastructure of these and other new growth drivers.

As the sole Clearing Bank for Renminbi business in Hong Kong, we will actively expand our RMB-related banking business. Leveraging our leading market position, experiences and capabilities, we will capture business opportunities arising from the launch of cross-border RMB trade settlement services to foster the growth of a wide spectrum of related services for our corporate customers, including remittances, collections and letter of credit services between Hong Kong and designated cities in the Mainland. To coincide with the latest developments in the Mainland, we will further enhance our "RMB Merchant Link" service to provide a one-stop solution for corporate clients on the one hand while upgrading our "Integrated RMB Services" for individual customers on the other hand.

We will engage in closer collaboration with our parent, BOC, for mutual gains. With the mandate as BOC's Asia-Pacific Syndicated Loan Centre, we will play an even more active role in identifying potential clients and securing loan syndication business in the region. The introduction of the pilot scheme of "Global Relationship Manager" by BOC in April will enable us, as a partner of the scheme, to enhance service capability to high-end corporate customers around the world. Given our experiences and capabilities built up over decades in an international financial centre like Hong Kong, we will seek to function as BOC Group's product manufacturing centre and service supporting centre in the Asia-Pacific region.

To conclude, I believe the Group has come through the global financial turmoil with our fundamentals being intact and we are now in better shape to move on, seize new opportunities and meet new challenges ahead of us. With the continued guidance of the Board and support of shareholders, customers and staff, I am confident that the Group will be able to reach a new horizon in the ever-changing financial landscape, which will in turn create higher value to our stakeholders.

HE Guangbei
Vice Chairman & Chief Executive

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