The operating environment for the banking industry in Hong Kong continued to stabilise in the first half of 2010. We witnessed strong economic growth spurred by the rise in domestic consumption, business investment, export of goods, inbound tourism as well as investment in property. These gave rise to demand for credit and banking services. However, the recovery of major economies from the global financial crisis was still far from smooth. International financial markets remained volatile. Interest rates stayed at an exceptionally low level, which had a direct impact on banks' net interest income. Competition intensified and the cost of operation escalated with inflation.

Despite these challenges, we focused on growing our traditional businesses by capitalising on our solid foundations and unique competitiveness. In the first six months, we maintained our growth momentum for core businesses and solidified our market lead in key areas. Of equal, if not more, importance, we have succeeded in capturing various new business opportunities. In particular, we made significant headway in expanding the scope and geographical reach of our RMB-related business. We also further strengthened our leading position in offering cross-border banking services. In view of the uncertainties that still prevailed in the market, we took effective steps to further enhance our risk management, boost our capital strength and ensure our liquidity position.

Business Highlights

Our key business results in the first half of 2010 are highlighted as follows:

- By taking advantage of the reviving economy to drive business growth and improve profitability, we continued to grow our profit attributable to shareholders by a healthy margin. We recorded robust growth in total assets.

- We managed to maintain our net interest income in an unfavourable interest rate environment.

- Our lending business registered strong broad-based growth, led by corporate lending, trade finance, residential mortgage and our Mainland operation. In view of the changes in the market, we have proactively adjusted our lending strategy in the latter part of this reporting period in order to strike a better balance among growth, return and risks.

- Despite fierce competition in the market, we achieved an inspiring increase in customers' deposits with strong performance of RMB deposits.

- We maintained our leading market positions in corporate lending, loan syndication, residential mortgage and RMB-related business in Hong Kong. Our life insurance business recorded significant growth in the first half.

- We made various breakthroughs in our RMB banking business. An important milestone is that we have extended our reach beyond Hong Kong to the world. In line with the steady opening of RMB business, we pioneered a significant number of new RMB services in trade settlement and finance, corporate lending and corporate bonds. Our launch of the CNY HIBOR as a reference rate for RMB trade settlement and commercial loans in Hong Kong was applauded by the market.

- Our ability to innovate in cross-border financial services is apparent. We broadened our custody services to QDIIs in China and offered an increasing number of wealth management solutions for corporate and individual clients in the Mainland.

- We made considerable progress in our collaboration with BOC which resulted in major achievements in such key areas as offering global service for major corporate clients of both banks, extension of credit card business for BOC's overseas branches, providing support to these branches by our call centre, as well as IT cooperation on many business fronts.

- The Group's asset quality has proved to be excellent. Our classified or impaired loan ratio kept improving to the best level in the local market.

- We successfully issued two subordinated notes in February and April of this year respectively to repay the USD Subordinated Credit Facility provided by BOC in 2008, which broadened our investor base, established a market benchmark, diversified our funding channels and enhanced our international profile. Our capital adequacy ratio stayed at a level which is strong for sustaining our growth and development.

Financial Performance

In the first six months of 2010, profit attributable to the Company's shareholders increased by 7.5% to HK$7,190 million, which was due primarily to the stable contributions from most of our core business earnings and a net reversal of impairment allowances on securities investments.

The Group's net operating income before impairment allowances was HK$12,541 million, down 3.7% year-on-year. Operating profit before impairment allowances was HK$8,007 million, 9.4% lower as compared with the first half of 2009 but improved significantly by 57.6% from the second half of the year. Return on average total assets (ROA) and return on average capital and reserves attributable to the equity holders (ROE) were 1.17% and 13.72% respectively, versus 1.23% and 15.13% respectively for the first half of 2009.

Net interest income was stable at HK$8,964 million as the net interest margin (NIM) narrowed by 21 basis points year-on-year to 1.58%. This decrease was, however, largely offset by a growth of 12.6% in the Group's average interest-earning assets which reached HK$1,142,383 million. It should be noted that we have taken initiatives to improve the pricing of new corporate loans during the period.

Net fee and commission income grew by 15.3% year-on-year to HK$3,397 million. This was led mainly by the hefty rise in loan commissions of 56.5%, made possible by the Group's expanded lending. Fees from our credit card business increased by an impressive 28.1%. Satisfactory growth was also recorded in fee income from other traditional banking businesses such as bills, payments services and currency exchange. Compared to the second half of 2009, net fee and commission income dropped slightly by 4.6% due to the decline in stock brokerage fee income in a less buoyant market.

There was a net trading loss of HK$36 million in the first half versus a net trading gain of HK$804 million in the same period of 2009. This was caused mainly by foreign exchange (FX) losses on foreign exchange swap contracts and a mark-to-market loss on interest rate swap contracts, which will be reversed upon maturity of the contracts. FX swap contracts were used for the Group's funding activities and liquidity management; despite FX losses, there were interest differentials generated from these contracts and reflected in higher net interest income.

Riding on the growth momentum built up last year in our lending business, total loans and advances to customers grew by 20.2% year-on-year and 11.0% half-on-half to HK$571,486 million. Over the interim period, corporate loans increased by 14.3%, trade finance by 34.0% and residential mortgage loans by 3.4%. Loans for use in Hong Kong were up 9.4% whereas loans for use outside Hong Kong were up 10.3%.

The Group's total assets increased by 7.4% over the 6-month period to HK$1,302,176 million by 30 June 2010. Our effective risk management ensured the high quality of our assets. The classified or impaired loan ratio as at end-June of 2010 was 0.23%, versus 0.34% six months ago and 0.37% twelve months ago.

On the expenditure side, we continued to be highly cost-conscious throughout the period under review. Total operating expenses increased by 8.1% to HK$4,534 million, which was primarily due to the rise in staff costs connected with higher accrual of performance-linked remuneration and increased human resources inputs in our Mainland operation. Business growth and development, including marketing and promotion in both the local and Mainland markets, also accounted for part of the total increase.

Our capital and liquidity positions remained strong. Consolidated capital adequacy ratio (CAR) as at 30 June 2010 was 16.17%, versus 16.10% as at 30 June and 16.85% as at the end of 2009. Core capital ratio was at 11.33%. The average liquidity ratio stayed at a healthy level of 37.81%, compared to 39.70% a year ago.

Business Review

Our operating performance in the first two quarters duly reflects our competence and incessant effort in driving business growth and development.

Personal Banking

During the first half of 2010, Personal Banking took full advantage of the improved market environment to grow its core segments, including residential mortgage, life insurance, wealth management, RMB banking and credit card business. It recorded an operating income of HK$5,316 million and a profit before taxation of HK$2,230 million, up 4.9% and 0.6% year-on-year respectively.

Through product innovation and strategic alliance with property developers, we grew our underwriting of new mortgages and maintained our market lead in the first half of the year. The Group's outstanding mortgage loans were up 3.4% versus the end of 2009. The quality of mortgage loans remained sound under rigorous risk assessment and control. The delinquency and rescheduled loan ratio stood at a low 0.03% by 30 June 2010.

In the interim period, sentiment in the local stock market was adversely affected by the external environment, in particular the sovereign debt crisis in Europe. This inevitably had a negative impact on our stock brokerage business and related fee income. Despite that, we attached great importance to enhance our products and services and put emphasis on acquiring new customers in both Hong Kong and the Mainland, thus effectively enlarging our stock-trading customer base.

Our Bancassurance business recorded significant growth in the period under review as a result of an expanded product spectrum. This not only led to a strong growth in sales income but reinforced our prominent position in the local life insurance market.

We continued to broaden our wealth management customer base by means of service differentiation and customisation. New promotional offers were launched to attract and retain high net-worth customers. By collaborating with BOC, we further expanded our cross-border wealth management services and provided more tailor-made services to customers in the Mainland and Hong Kong. In the first six months of 2010, the total number of wealth management customers and the amount of assets under our management increased by 6.7% and 1.5% respectively from the end of 2009.

The performance of the Group's credit card business was highly satisfactory in the interim period. Encouraging growth was recorded in card issuance (up by 9.3% compared with end-2009), cardholder spending and merchant acquiring (up by 21.4% and 41.8% respectively compared with the first half of 2009). The loan quality of card advances stayed excellent with the annualised charge-off ratio standing at 1.56%.

We reinforced our leading position in RMB banking services in Hong Kong by focusing on RMB integrated services, "RMB Remittance Express" and "RMB Exchange Express". Our RMB deposit-taking business in Hong Kong continued to flourish. We also remained the market leader in the RMB credit card business with the number of China Union Pay ("CUP") Dual Currency Credit Card issued by us grew by 45.5% versus six months ago, reaching a total of about 530,000 by the end of June. We are glad to witness that the Group was well ahead of the market in CUP merchant acquiring business through a host of merchant offers in Hong Kong, Macau and the Mainland, with merchant acquiring volume and cardholder spending up by 69.3% and 157.5% respectively year-on-year. Meanwhile, we launched the first RMB life insurance product in Hong Kong which was well-received by customers.

Corporate Banking

The Group's Corporate Banking business experienced robust growth, solidified its market position in key segments and expanded its service range during the interim period. Operating income was HK$4,459 million, up 16.1% year-on-year. Profit before taxation was HK$3,358 million, up 14.4%.

By meeting the rise in demand in Hong Kong while stepping up the development of cross-border financial services for Mainland corporate clients, we recorded a solid growth of 14.3% in our corporate loan portfolio as compared to end-2009. We also maintained our position as the top mandated arranger in the Hong Kong-Macau syndicated loan market. These enabled us to increase our loan commission income substantially.

We expanded our SME business by actively promoting both the "SME Loan Guarantee Scheme" and "Special SME Loan Guarantee Scheme" in support of the HKSAR Government's initiatives to help SMEs. Meanwhile, we worked closely with BOC, NCB (China) and major trade associations to promote our SME services. We took great pleasure in receiving the "SME's Best Partner Award" for the third consecutive year granted by the Hong Kong Chamber of Small and Medium Business Limited.

We made considerable advancement in our RMB-related banking services following the announcement by the Hong Kong Monetary Authority (HKMA) of the "Elucidation of Supervisory Principles and Operational Arrangements Regarding RMB Business in Hong Kong" in February this year, which allowed a greater degree of flexibility in conducting RMB banking business. The Group then took the initiative in introducing a new range of RMB-related services to the market to meet the demand of our customers. We extended the first RMB export invoice finance, the first RMB import invoice finance, the first RMB working capital loan, as well as RMB remittance service for dividend payout. We also took advantage of the geographical expansion of the Cross-border RMB Trade Settlement Services Pilot Programme from 5 cities to 20 cities and provinces by enlarging our services to corporate clients in all the pilot cities.

Benefiting from the revival of global trade, our trade finance business experienced an impressive half-year growth of 34.0% while bills commission rose by 19.7% year-on-year. We retained our market share in the trade finance business amid fierce competition.

Meanwhile, our custody services continued to thrive and are now spread to a number of Mainland clients, including major banks and other financial institutions. By 30 June 2010, total assets under our custody reached HK$384 billion. Through service enhancement, our cash management business also prospered by attracting a large number of customers. With the linkage with BOC and its overseas branches, our cash management service platform greatly facilitated customers in fund transfers between Hong Kong, the Mainland and a number of countries in the region.

Mainland Business

The Group's Mainland business recorded satisfactory growth in the first half of the year. Customer deposits increased by 60.6% while total advances to customers grew by 18.2%. Total operating income increased by 11.8% to HK$521 million, driven mainly by the rise in net interest income. Profit before taxation was HK$256 million, down 16.9% as a result of higher operating expenses, necessitated by inputs for business development, and lower contribution from recoveries as compared with the first half of 2009. The asset quality remained good, with the classified loan ratio standing at 0.37% versus 0.44% at 31 December 2009.

Our branch network in China kept expanding. NCB (China)'s Wuxi branch was opened for operation in July and approval has been obtained for NCB (China) to open new sub-branches in Shanghai and Beijing respectively.

Treasury

Fully alert to the volatile situation in the global investment market, we have been pursuing a prudent yet proactive approach in managing our investment portfolio in order to guard against risks while maximising return. Having regard to the market situation, in the first quarter we increased our investments in fixed rate debt securities, including government-related securities and higher quality bonds issued by financial institutions and corporates, to optimise interest return. In the second quarter, in view of the sovereign debt crisis in Europe, we chose to focus more on quality corporate bonds.

In terms of business development, we continued to concentrate on traditional products related to foreign exchange and precious metals which yielded good results. Hedging products linked to foreign exchange were offered to offshore customers. We also deepened our cooperation with BOC's overseas branches to conduct RMB exchange business.

In the interim period, the Treasury segment recorded an operating income of HK$2,376 million, down 36.6%. Of which, net interest income dropped as part of the residual funds were redeployed to lending, whereas non-interest income was affected by factors as explained earlier in the paragraph of net trading gain. Profit before taxation was down 3.0% to HK$2,118 million.

Insurance

The Group's Insurance business recorded a profit before taxation of HK$106 million, down 31.6% year-on-year because of higher commission expenses resulting from the substantial increase in new business.

We continued to expand our product range which led directly to the continuous growth in premium income in the first half. In line with the further opening of RMB business, we introduced new RMB insurance products which are settled in RMB or HKD. The demand for such products was encouraging which contributed to reinforcing our lead in the local RMB insurance market.

Outlook

For the global economy, the road to full recovery after the 2008 financial crisis is expected to be long and uneven. We are also aware of the uncertainties that still prevail in the global financial markets. Despite the solid economic growth witnessed in Hong Kong in the past year or so, we cannot assume that it can be entirely immune from the uncertainties and potential pitfalls in the external environment. For banks, interest rates are still likely to stay at the current low level for longer than originally expected, which means that the pressure on net interest margin and net interest income will not be lifted in the foreseeable future. The competition for business is therefore expected to intensify.

In view of these challenges, we will continue to adopt a proactive but prudent approach in conducting our business in the remainder of the year. On the one hand, we will leverage our competitive advantages to capture new opportunities in order to grow our core businesses. On the other hand, we will remain extremely vigilant over our capital strength, the maintenance of liquidity, risk management and cost control. While striving for business growth, we will focus not just on volume but also on quality and sustainability to ensure risk-adjusted return.

With the increasing significance of RMB in the global economy, RMB-related banking business is now becoming a growth engine for Hong Kong's banking sector in general and our Group in particular. As can be expected, the "Supplementary Memorandum of Cooperation on RMB Business" signed between the HKMA and the People's Bank of China (PBoC) as well as the revised "Settlement Agreement on the Clearing of RMB Businesses" signed between BOCHK and PBoC on 19 July this year will be highly conducive to the robust development of Hong Kong's RMB banking business. Given our unrivalled status as the sole RMB clearing bank in Hong Kong, our strong track record in conducting RMB business, our close relationship with BOC and extensive connection in the Mainland, we believe we are in a superior position to broaden the scope of our RMB banking services for both corporate and individual customers as well as financial institutions on both sides of the border and across the world.

Right at the beginning of the second half of 2010, we marked a number of new milestones in our RMB business, namely, acting as the Sole Bookrunner and Lead Manager of the first RMB corporate bonds issued in Hong Kong, conducting the first CNY deliverable forwards transaction for our corporate clients, launching BOC Wealth Express Card and BOC CUP Dual Currency Credit Card Shenzhen-Hong Kong Cross Border Autopay Service, and the like. While solidifying our strong RMB branding, we are now able to provide a comprehensive range of professional RMB services to meet the diverse needs of customers, thus ensuring the premier choices for them.

We are currently providing RMB clearing service to over 100 participating banks. Now that the scope of RMB business clearing service has been extended from Hong Kong, Macau and ASEAN countries to the world, we will, as always, continue to provide impartial, timely, accurate and professional RMB clearing services to all the participating banks in Hong Kong and overseas. The latest development is that in July this year, we signed the Agreement on Provision of Clearing Service for RMB Cashnotes Business for Taiwan with PBoC, which allows us to extend our RMB clearing service for the Taiwan region.

We have entered a new horizon which will help, together with other developments, promote Hong Kong's status as an offshore RMB centre.

Against the backdrop of uncertainties in western economies, the Mainland of China remains the most rapidly growing market and is the bright spot in the eyes of global investors. Benefiting from the "Framework Agreement on Hong Kong-Guangdong Cooperation" signed in April this year, we expect business opportunities in the neighbouring Pearl River Delta (PRD) to proliferate. The demand will rise among affluent customers for wealth management services. We will continue to build up our high net-worth customer base by offering and customising wealth management solutions. At the same time, the demand among commercial clients for more extensive financial services that cover the whole region or beyond is also expected to increase rapidly. Capitalising on our strong franchise and close connection with our parent, we will provide a full suite of service for these clients with enormous potentials.

To sustain the growth and leading marketing positions in our core traditional businesses, we strive to enhance our business service platform, optimise our distribution channel, heighten our product development capabilities and expand our customer base. Among others, the recent launch of BOCHK Mobile Banking offers a secure and reliable banking service platform for our customers. Our dynamic, brand-new flagship model branches will also help strengthen our strong brand franchise and integrated service capabilities for customers. All these will enable us to better serve as BOC Group's product manufacturing centre and service supporting centre in the Asia-Pacific region.

Apart from business development, we will endeavour to fulfill our corporate social responsibility, which has become an integral part of the Group's long-term development strategy. We are pleased that the Company has been recently selected as a constituent stock for the Hang Seng Corporate Sustainability Index. We also won the Hong Kong Community Chest Top Donor of the Year Award in July. I am sure the Group and its staff will be further committed on that score in the time ahead.

To conclude, I believe the Group has been coping well with the challenges of the operating environment and positioning itself strategically for the long-term sustainable growth and development, for which I must extend my heartfelt thanks to the Board, our shareholders, our customers and all my colleagues.

HE Guangbei
Vice Chairman & Chief Executive

26 August 2010