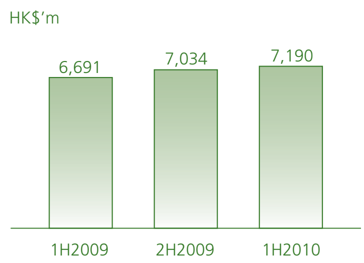
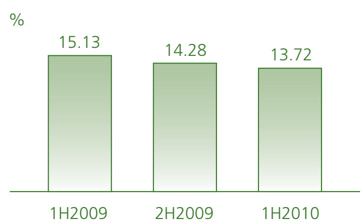
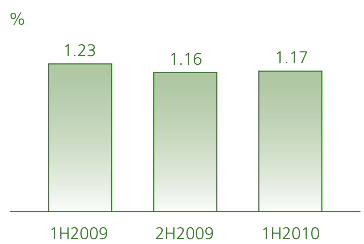
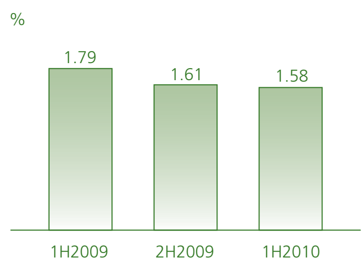
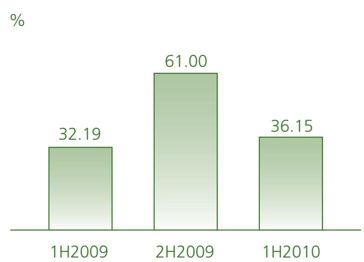
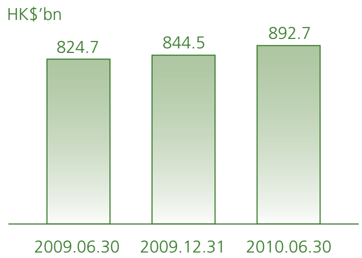
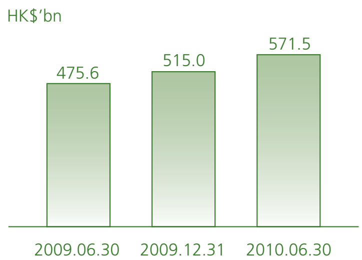
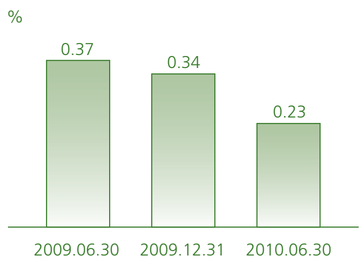
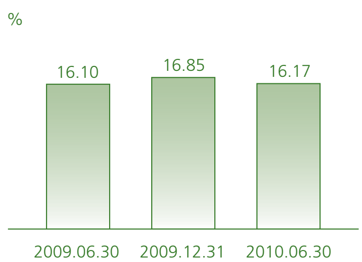
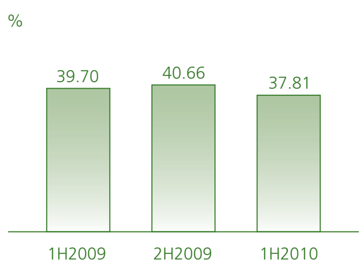
The following sections provide metrics and analytics of the Group's performance, financial positions, and risk management. These should be read in conjunction with the financial information included in this Interim Report.

FINANCIAL PERFORMANCE AND CONDITION IN BRIEF

The following table is a summary of the Group's key financial results for the first half of 2010 with a comparison with the previous two half-yearly periods.

Financial Indicators		2010 First Half Performance
1. Profit Attributable to Shareholders		**Profit attributable to shareholders** • The Group's profit continued to grow. Profit attributable to shareholders was HK$7,190 million, up HK$499 million, or 7.5%, year-on-year.
2. Return on Average Capital and Reserves Attributable to the Equity Holders of the Company ("ROE")[1]		**ROE** • ROE was 13.72%, down 1.41 percentage points year-on-year as the increase in reserves outpaced that of the Group's profit.
3. Return on Average Total Assets ("ROA")[2]		**ROA** • ROA was 1.17%, down 0.06 percentage point year-on-year.
4. Net Interest Margin ("NIM")		**NIM** • NIM was 1.58%, down 21 basis points year-on-year due to lower market interest rates and intense pricing competition.
5. Cost-to-Income Ratio ("CIR")		**CIR** • CIR was 36.15%, up 3.96 percentage points year-on-year mainly due to the increase in operating expenses. • CIR was lower than in the second half of 2009 when significant expenses were incurred on Lehman Brothers-related products.

<table>
<tr><th colspan="2">Financial Indicators</th><th>2010 First Half Performance</th></tr>
<tr><td>6. Deposits from Customers (including structured deposits)</td><td>
</td><td>Deposits from Customers
• Total deposits increased by 5.7% from the end of 2009, with strong performance of RMB deposits.</td></tr>
<tr><td>7. Advances to Customers</td><td>
</td><td>Advances to Customers
• Advances to customers continued its growth momentum and rose by 11.0% from the end of 2009. The Group has also made progress in improving pricing of loans this year with market demand.</td></tr>
<tr><td>8. Classified or Impaired Loan Ratio[3]</td><td>
</td><td>Classified or Impaired Loan Ratio
• Classified or impaired loan ratio was 0.23%, down 0.11 percentage point from the end of 2009.
• Formation of new classified loans remained at a low level, representing approximately 0.03% of total loans.</td></tr>
<tr><td>9. Capital Adequacy Ratio ("CAR")</td><td>
</td><td>CAR
• CAR was maintained at a high level of 16.17%.
• Core capital ratio was at a solid level of 11.33%.</td></tr>
<tr><td>10. Average Liquidity Ratio</td><td>
</td><td>Average Liquidity Ratio
• Average liquidity ratio was at a comfortable level of 37.81%.</td></tr>
</table>

1 Return on Average Capital and Reserves Attributable to the Equity Holders of the Company as defined in "Financial Highlights".

2 Return on Average Total Assets as defined in "Financial Highlights".

3 Classified or impaired loans represent advances which have been classified as "substandard", "doubtful" or "loss" under the Group's classification of loan quality, or individually assessed to be impaired.

ECONOMIC BACKGROUND AND OPERATING ENVIRONMENT

The recovery of the global economy extended to the first half of 2010. Among the world's major economies, China continued with its strong growth in 2010 despite the tightening of its monetary policy. The Hong Kong economy achieved an impressive annualised GDP growth of 8.2% in the first quarter of the year spurred by an increase in retail sales as well as higher exports of goods and services. The unemployment rate dropped to 4.6% in the second quarter of the year. The pressure on inflation was becoming more visible due to the rise in wages and import prices. Hong Kong's Composite Consumer Price Index grew by 2.8% in June 2010 over the same month a year earlier. Meanwhile, the recent European sovereign debt crisis and the potential tightening of monetary policies by major central banks added uncertainties to the market.

Market interest rates remained at a low level with ample liquidity in the market. Average 1-month HIBOR and LIBOR stayed close to zero in the first half of 2010.

Investors' sentiments in the Hong Kong stock market turned less positive in the first half of 2010. The risk appetite of investors was further weakened towards the end of the first half of 2010 in light of the worsening of the European debt crisis and the tightening of the Mainland's policy. After reaching 22,417 on 6 January 2010, the Hang Seng Index closed at 20,129 on 30 June 2010.

The local residential property market remained buoyant in the first half of 2010 as property prices and transaction volume continued to rise. The number of sales and purchase agreements of all building units registered a 31.3% increase versus the same period in 2009, while the prices of private domestic properties showed an increase of 8.1% from end-2009.

During the first half of 2010, the competition for both loans and deposits continued to intensify. Despite the higher demand for mortgage loans, particularly those in HIBOR-based as customers take advantage of the low interbank rates, banks had to offer lower rates to attract customers. On the other hand, higher rates were being offered to depositors to attract funds from the market.

On 11 February 2010, Hong Kong Monetary Authority announced the "Elucidation of Supervisory Principles and Operational Arrangements Regarding Renminbi Business in Hong Kong" ("Elucidation"), with an aim to increase the flexibility in developing diversified RMB-denominated financial services. The Elucidation helped simplifying, enhancing and providing convenient operational procedures for the business of cross-border trade settlement in RMB, and thus leading to greater flexibility and offering more favourable development prospects for the RMB business.

In summary, the operating environment of the banking industry improved in general alongside the revival of both the global and local economies. However, it remained highly challenging as banks were faced with persistent pressure on their net interest margin in the low interest rate environment, intensifying competition on pricing, greater inflationary pressure on operating cost and uncertainties triggered by the recent European sovereign debt crisis.

CONSOLIDATED FINANCIAL REVIEW

Financial Performance

The economic recovery in Hong Kong gathered pace in the first half of 2010. However, the market interest rate still stood at an exceptionally low level and competition remained intense in the banking industry. By capitalising on its core competencies and competitive advantages, the Group managed to seize opportunities arising from the recovering economy and achieved business growth. Meanwhile, it continued to exercise stringent risk management in view of the economic uncertainties arising from the debt crisis in Europe and the potential tightening of monetary policies in certain countries.

Compared to the first half of 2009, the core earnings[1] of the Group remained stable. However, substantial mark-to-market losses led to a drop in operating income of HK$487 million or 3.7%. Meanwhile, operating expenses rose from a relatively low level in the first half of 2009. As a result, the Group's operating profit before impairment allowances declined by HK$827 million or 9.4%. The Group recorded a net reversal of impairment allowances on securities investments versus a significant net charge in the first half of 2009. The net reversal of impairment allowances on loans remained at a low level. The Group's profit attributable to shareholders increased by HK$499 million, or 7.5%, to HK$7,190 million. Earnings per share were HK$0.68, up HK$0.0471 from the same period last year. ROA was 1.17% while ROE was 13.72%.

As compared to the second half of 2009, the Group's profit attributable to shareholders increased by HK$156 million, or 2.2%. During the period, net interest income rose slightly. However, both net trading gain and net fee and commission income registered a decline. Operating expenses declined as significant expenses were incurred on Lehman Brothers-related products in the second half of 2009. The Group also recorded a net gain on the disposal of securities investments. Meanwhile, net reversal of impairment allowances on securities investments dropped substantially while a modest amount of net reversal of impairment allowances on loans was recorded as opposed to a net charge in the second half of 2009.

1 Core earnings include net interest income, net fee and commission income and net trading gain of the banking business which excludes mark-to-market gain or loss but includes foreign exchange gain or loss from foreign exchange swap contracts.

Financial Highlights

HK$'m, except percentage amounts	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
Net interest income	**8,964**	8,918	9,014
Other operating income	**3,577**	4,109	4,014
Operating income	**12,541**	13,027	13,028
Operating expenses	**(4,534)**	(7,947)	(4,194)
Operating profit before impairment allowances	**8,007**	5,080	8,834
Net reversal/(charge) of impairment allowances	**161**	2,305	(1,115)
Others	**599**	1,095	525
Profit before taxation	**8,767**	8,480	8,244
Profit attributable to equity holders of the Company	**7,190**	7,034	6,691
Earnings per share (HK$)	**0.6800**	0.6652	0.6329
Return on average total assets	**1.17%**	1.16%	1.23%
Return on average capital and reserves attributable to the equity holders of the Company	**13.72%**	14.28%	15.13%
Net interest margin (NIM)	**1.58%**	1.61%	1.79%
Non-interest income ratio	**28.52%**	31.54%	30.81%
Cost-to-income ratio	**36.15%**	61.00%	32.19%

Analyses of the Group's financial performance and business operations are set out in the following sections.

Net Interest Income and Margin

HK$'m, except percentage amounts	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
Interest income	**10,671**	10,353	11,331
Interest expense	**(1,707)**	(1,435)	(2,317)
Net interest income	**8,964**	8,918	9,014
Average interest-earning assets	**1,142,383**	1,101,861	1,014,954
Net interest spread	**1.53%**	1.56%	1.73%
Net interest margin	**1.58%**	1.61%	1.79%

In the first half of 2010, short-term market interest rates remained at a low level, which could be attributed to ongoing accommodative monetary policies rates in major economies and ample liquidity in the interbank market. Compared to the first half of 2009, average one-month HIBOR and average one-month LIBOR fell by 8 basis points and 15 basis points to 0.13% and 0.27% respectively, while average three-month HIBOR and average three-month LIBOR declined by 53 basis points and 69 basis points to 0.19% and 0.35% respectively. The Group's average HKD Prime rate remained at 5.00% thus widening the HKD Prime-to-one-month HIBOR spread by 8 basis points to 4.87%.

Compared to the first half of 2009, the Group's net interest income decreased slightly by HK$50 million, or 0.6% to HK$8,964 million. The decline was mainly due to the narrowing of the net interest margin by 21 basis points to 1.58%, which was mostly offset by the 12.6% growth in average interest-earning assets. The contribution of net free fund fell by 1 basis point.

Average yield of interest-earning assets fell by 37 basis points while the average rate of interest-bearing liabilities dropped by 17 basis points. As a result, the net interest spread decreased by 20 basis points under the low interest rate environment.

The narrowing of spread was primarily due to the decline in the average yield of total interest-earning assets. Average gross yield on loans and advances to customers and debt securities were down by 37 and 34 basis points respectively. Loan yield was compressed by the decline in market rates and greater pricing pressure, particularly on mortgage loans, as a result of intense market competition. In addition, there was a bigger proportion of HIBOR-based residential mortgage loans and large corporate loans the pricing of which was based on interbank market rates (hereafter called "market rate-based loans"). This exerted pressure on the average yield of the Group's loans as market rate-based loans bore a lower gross yield relative to Prime-based loans amid the current interest rate environment. Nevertheless, the Group focused on enhancing the pricing of its corporate lending and improved the pricing of new corporate loans during the period. Gross yield of debt securities declined following their repricing at lower interest rates. Meanwhile, the average rate of interest-bearing liabilities dropped by a lesser extent as deposit costs were already close to zero.

On the other hand, the Group's assets and liabilities mix improved. The increase in higher-yielding assets such as loans and advances to customers as well as debt securities investments, coupled with the increase in the proportion of demand, current and savings deposits in average total deposits partly offset the decline in interest spread.

ASSETS	**Half-year ended 30 June 2010**		Half-year ended 31 December 2009*		Half-year ended 30 June 2009*	
	Average balance HK$'m	**Average yield %**	Average balance HK$'m	Average yield %	Average balance HK$'m	Average yield %
Cash, balances and placements with banks and other financial institutions	**211,521**	**0.95**	253,525	0.91	230,145	1.55
Debt securities investments	**369,306**	**2.28**	338,254	2.30	322,004	2.62
Loans and advances to customers	**547,281**	**2.00**	495,723	2.07	451,694	2.37
Other interest-earning assets	**14,275**	**1.26**	14,359	1.17	11,111	1.09
Total interest-earning assets	**1,142,383**	**1.88**	1,101,861	1.86	1,014,954	2.25
Non interest-earning assets	**116,018**	**–**	130,059	–	106,807	–
Total assets	**1,258,401**	**1.71**	1,231, 920	1.67	1,121,761	2.04

LIABILITIES	**Half-year ended 30 June 2010**		Half-year ended 31 December 2009*		Half-year ended 30 June 2009*	
	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	**105,914**	**0.58**	76,382	0.63	73,058	0.78
Current, savings and fixed deposits	**807,886**	**0.27**	821,150	0.19	763,867	0.39
Certificates of deposit issued	**–**	**–**	198	4.04	845	4.07
Subordinated liabilities	**26,373**	**2.10**	27,001	2.90	27,185	3.91
Other interest-bearing liabilities	**39,572**	**0.31**	31,879	0.13	27,745	0.24
Total interest-bearing liabilities	**979,745**	**0.35**	956,610	0.30	892,700	0.52
Non interest-bearing deposits	**57,847**	**–**	68,806	–	44,193	–
Shareholders' funds# and non interest-bearing liabilities	**220,809**	**–**	206,504	–	184,868	–
Total liabilities	**1,258,401**	**0.27**	1,231,920	0.23	1,121,761	0.42

* Interest income and expense for interest rate derivatives held for trading have been reclassified from "Net interest income" to "Net trading (loss)/gain". The comparative figures have been reclassified to conform with the current period's presentation.

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

Compared to the second half of 2009, average one-month HIBOR increased by 4 basis points to 0.13% while average one-month LIBOR increased by 2 basis points to 0.27%. The Group's net interest income increased slightly by HK$46 million or 0.5%. Net interest margin and net interest spread each narrowed by 3 basis points.

Net interest income increased as average interest-earning assets recorded a growth of 3.7%. However net interest spread narrowed mainly due to an increase in deposit costs amid acute competition. The negative effects were partly offset by the improvement in the assets mix with the growth in loans and advances to customers and debt securities investments.

Net Fee and Commission Income

HK$'m	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
Investment and insurance fee income	**1,748**	2,145	1,741
Securities brokerage (Stockbroking)	**1,506**	2,013	1,625
Securities brokerage (Bonds)	**3**	35	4
Funds distribution	**67**	59	38
Life insurance*	**172**	38	74
Credit cards	**903**	806	705
Loan commissions	**623**	524	398
Bills commissions	**371**	317	310
Payment services	**272**	268	227
Account services	**136**	144	132
Currency exchange	**125**	126	87
Trust services	**98**	96	82
General insurance	**48**	52	48
Correspondent banking	**24**	24	21
Custody	**17**	21	15
IPO-related business	**9**	40	1
Others	**107**	89	117
Fee and commission income	**4,481**	4,652	3,884
Fee and commission expenses	**(1,084)**	(1,091)	(937)
Net fee and commission income	**3,397**	3,561	2,947

* Fee income from life insurance only included that from the Group's insurance business partner after group consolidation elimination.

Net fee and commission income recorded a broad-based growth of HK$450 million or 15.3% year-on-year to HK$3,397 million, mainly driven by the strong growth of HK$225 million or 56.5% in loan commissions. Fee from the credit card business grew by HK$198 million or 28.1% with the increase in cardholder spending and merchant acquiring volume by 21.4% and 41.8% respectively. Fee and commission income arising from bills, payment services and currency exchange recorded satisfactory growth due to higher transaction volumes amid the economic recovery. Investment and insurance fee income, which is discussed in the next section "Investment and Insurance Business", remained largely the same. Meanwhile, fee and commission expenses rose by HK$147 million or 15.7%, mainly due to the increase in fee expenses in credit cards.

Compared to the second half of 2009, net fee and commission income dropped by HK$164 million or 4.6%, mainly because of the HK$507 million or 25.2% decrease in fee income from stock broking. On the other hand, fee income from life insurance rose by HK$134 million or 352.6% and loan commissions grew by HK$99 million or 18.9%. Fee income from credit cards increased by HK$97 million or 12.0% while bills commissions registered a growth of HK$54 million or 17.0%. Meanwhile, fee and commission expenses decreased slightly by HK$7 million or 0.6%, as the drop in fee expenses on stock broking was mostly offset by an increase in credit cards expenses.

Investment and Insurance Business

HK$'m	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
Investment and insurance fee income			
Securities brokerage (Stockbroking)	**1,506**	2,013	1,625
Securities brokerage (Bonds)	**3**	35	4
Funds distribution	**67**	59	38
Life insurance*	**172**	38	74
	1,748	2,145	1,741
Net operating income of BOC Life#			
Net insurance premium income	**2,798**	5,483	2,261
Interest income	**724**	709	562
Net gain/(loss) on financial instruments designated at fair value through profit or loss	**591**	636	(1,575)
Net gain on investment in securities	**118**	–	–
Others	**4**	5	5
Gross operating income of BOC Life#	**4,235**	6,833	1,253
Less: net insurance benefits and claims	**(3,875)**	(6,367)	(919)
	360	466	334
Total investment and insurance income	**2,108**	2,611	2,075
Of which: Life insurance fee income*	**172**	38	74
Net operating income of BOC Life#	**360**	466	334
Total life insurance income	**532**	504	408
Investment fee income	**1,576**	2,107	1,667
Total investment and insurance income	**2,108**	2,611	2,075

* Fee income from life insurance only included that from the Group's insurance business partner after group consolidation elimination.

\# Before commission expenses.

The Group's total investment and insurance income registered an increase of HK$33 million or 1.6% to HK$2,108 million compared to the same period last year. The increase was mainly attributable to the increase in the fee income from life insurance of HK$98 million or 132.4% which was driven by the increase in transaction volumes. Fee income from fund distribution also increased by HK$29 million or 76.3%. They were, however, partially offset by the HK$119 million or 7.3% decrease in fee income from stock broking.

Owing to the European debt crisis and the tightening of the Mainland's policy, investment sentiments in the local stock market turned less bullish in the second quarter of 2010. This had a negative impact on the Group's stock broking business and related fee income.

The increase in net operating income of BOC Life was mainly attributable to the increase in net insurance premium income. Following the launch of the new financial planning team and the "Need-based Selling" approach in 2009, the Group successfully boosted the sales of its insurance products with an increase of HK$537 million or 23.8% in net insurance premium income. Meanwhile, it recorded a net gain on financial instruments designated at fair value through profit and loss versus a net loss in the same period last year. The increase was substantially offset by an increase in net insurance benefits and claims which was set aside to support policyholders' benefits under the new business, as well as the movement in reserve caused by the drop of long-term interest rates.

Compared to the second half of 2009, total investment and insurance income dropped by HK$503 million or 19.3%. The decline was caused by a significant drop in fee income from stock broking by HK$507 million or 25.2% from a comparatively high level in the second half of 2009 when the equity market was buoyant. Income from BOC Life also decreased by HK$106 million or 22.7% from the second half of 2009 when its investment income benefited from the narrowing of credit spread.

Net Trading (Loss)/Gain

HK$'m	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
Foreign exchange and foreign exchange products	**350**	483	790
Interest rate instruments and items under fair value hedge	**(424)**	119	(57)
Equity instruments	**(20)**	9	17
Commodities	**58**	70	54
Net trading (loss)/gain	**(36)**	681	804

Net trading loss was HK$36 million, representing a HK$840 million decline from a net trading gain of HK$804 million in the first half of 2009, primarily due to the decrease in net trading gain from foreign exchange and related products, and the increase in net trading loss from interest rate instruments.

Net trading gain from foreign exchange and related products fell by HK$440 million or 55.7%, which was mainly attributable to the foreign exchange loss on foreign exchange swap contracts* compared to a gain in the first half of 2009. Should the impact of loss on foreign exchange swap contracts be excluded, the gain from other foreign exchange activities would have increased by 19.0%. As the signs of economic recovery became more apparent and the appreciation of RMB was expected, the demand for foreign exchange rebounded and the Group recorded a year-on-year growth in related gain. Net trading loss from interest rate instruments and items under fair value hedge increased by HK$367 million or 643.9%, mainly due to the mark-to-market loss on certain interest rate instruments. Net trading loss from equity instruments stood at HK$20 million as opposed to a gain of HK$17 million, mainly as a result of the mark-to-market loss on certain equity investments.

Compared to the second half of 2009, net trading gain declined by HK$717 million, which was mainly attributable to the mark-to-market loss on certain interest rate instruments. Meanwhile, trading gain from foreign exchange and related products fell by HK$133 million, or 27.5%, mainly due to the foreign exchange loss on foreign exchange swap contracts*.

* Foreign exchange swap contracts are usually used for the Group's liquidity management and funding activities. Under the foreign exchange swap contracts, the Group exchanges one currency (original currency) for another (swapped currency) at the spot exchange rate (spot transaction) and commits to reverse the spot transaction by exchanging the same currency pair at a future maturity at a predetermined rate (forward transaction). In this way, surplus funds in original currency are swapped into another currency for liquidity and funding purposes without any foreign exchange risk. The exchange difference between the spot and forward contracts is recognised as foreign exchange gain or loss (as included in "Net trading (loss)/gain"), while the corresponding interest differential between the surplus funds in original currency and swapped currency is reflected in net interest income.

Net Gain/(Loss) on Financial Instruments Designated at Fair Value through Profit or Loss

HK$'m	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
Banking business of the Group	**49**	81	180
BOC Life	**591**	636	(1,575)
Net gain/(loss) on financial instruments designated at fair value through profit or loss	**640**	717	(1,395)

Compared to the net loss of HK$1,395 million recorded in the first half of 2009, the Group recorded a net gain of HK$640 million on financial instruments designated at fair value through profit or loss in the first half of 2010. This resulted mainly from the mark-to-market gain on certain debt securities of BOC Life caused by the drop of market interest rates. The loss in the first half of 2009 was caused by mark-to-market loss on its debt investments portfolio due to increase in long-term market interest rates. These mark-to-market changes were substantially offset by the corresponding changes in policy reserves, as reflected in the changes in net insurance benefits and claims which were attributable to market interest rate movement.

Compared to the second half of 2009, net gain on financial instruments designated at fair value through profit or loss decreased by HK$77 million or 10.7% to HK$640 million. The gain in the second half of 2009 was mainly attributable to the mark-to-market gain of certain debt securities investments of BOC Life caused by the narrowing of credit spread as the capital market stabilised.

Operating Expenses

HK$'m, except percentage amounts	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
Staff costs	**2,526**	2,835	2,256
Premises and equipment expenses (excluding depreciation)	**574**	622	538
Depreciation on owned fixed assets	**556**	522	496
Other operating expenses	**878**	3,968	904
Total operating expenses	**4,534**	7,947	4,194
Cost-to-income ratio	**36.15%**	61.00%	32.19%

The Group's total operating expenses increased by HK$340 million, or 8.1%, to HK$4,534 million. Since 2008, the Group had implemented a number of cost containment measures in view of the weakening local economy and intensifying global financial crisis. As a result, the Group had been able to maintain comparatively lower operating expenses. As the market showed clearer signs of improvement since the second half of 2009, the Group gradually incurred additional costs on marketing and promotion as well as business expansion in areas of its strategic focus such as the Mainland market. Nevertheless, the Group remained focused on operational efficiency and cost control in the first half of 2010.

Staff costs increased by HK$270 million or 12.0%, primarily due to higher accrual of performance-related remuneration and the increase in human resources for the Mainland operation. Compared to 30 June 2009, headcount measured in full-time equivalents rose by 220 to 13,429 as at 30 June 2010.

Premises and equipment expenses increased by HK$36 million or 6.7% as a result of higher IT costs and higher rental for branches in Hong Kong and new branches in the Mainland. Depreciation on owned fixed assets rose by HK$60 million or 12.1%, which was attributable to larger depreciation charge on premises and computer equipment.

Other operating expenses decreased by HK$26 million or 2.9% mainly due to expenses incurred on Lehman Brothers-related products in the first half of 2009 amounted to HK$222 million. Meanwhile, in the first half of 2010, the Group incurred higher marketing and promotion expenses as well as expenses connected with the improved business volume.

Compared to the second half of 2009, operating expenses decreased by HK$3,413 million or 42.9%. This was largely due to expenses incurred for Lehman Brothers-related products amounted to HK$3,056 million, as well as higher staff costs and promotional expenses in the second half of 2009.

Net Reversal/(Charge) of Loan Impairment Allowances

HK$'m	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
Individual assessment – net reversal/(charge) of allowances before recoveries	**56**	(165)	(76)
Collective assessment – net charge of allowances before recoveries	**(256)**	(319)	(24)
Recoveries	**294**	321	160
Net reversal/(charge) of loan impairment allowances	**94**	(163)	60

The Group's loan quality continued to improve. Loan impairment allowances recorded a net reversal of HK$94 million in the first half of 2010. There was a net reversal of HK$56 million and a net charge of HK$256 million of loan impairment allowances before recoveries from individual and collective assessment respectively. Meanwhile, total recoveries stood at HK$294 million.

The net reversal of individual impairment allowances before recoveries in the current period as opposed to the net charge of HK$76 million in the first half of 2009 was mainly due to improved loan quality under the economic recovery. Meanwhile net charge of collective impairment allowances before recoveries increased by HK$232 million as a result of the refinement of the collective assessment methodology since the second half of 2009 and higher loan growth in the first half of 2010.

Compared to the second half of 2009, loan impairment allowances improved from a net charge of HK$163 million to a net reversal of HK$94 million. The higher net charge of individual impairment allowances before recoveries in the second half of 2009 was attributable to the downgrade of certain customers during the period.

Net Reversal/(Charge) of Impairment Allowances on Securities Investments

HK$'m	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
Held-to-maturity securities	**32**	1,129	(439)
Available-for-sale securities	**40**	1,341	(729)
Net reversal/(charge) of impairment allowances on securities investments	**72**	2,470	(1,168)

The reviving economy and stable capital market had a positive impact on the Group's securities investments portfolio. Following the disposal and repayment of securities, the Group recorded a net reversal of impairment allowances of HK$72 million. The table below illustrates the breakdown of the Group's net reversal or charge of impairment allowances against its securities investments in the first half of 2010 and the corresponding periods in 2009.

HK$'m	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
US non-agency residential mortgage-backed securities			
Subprime	**10**	53	(23)
Alt-A	**6**	189	(173)
Prime	**29**	2,156	(1,016)
	45	2,398	(1,212)
Other debt securities	**27**	72	44
Total net reversal/(charge) of impairment allowances on securities investments	**72**	2,470	(1,168)

For details about the composition of the Group's investment securities portfolio, please refer to Note 24 to the Interim Financial Information.

Compared to the second half of 2009, the Group recorded a significantly lower reversal of impairment allowances in the first half of 2010. The balance of impairment allowances had decreased considerably as a result of the Group's active disposal of US non-agency residential mortgage-backed securities ("RMBS") in the second half of 2009.

Property Revaluation

HK$'m	**Half-year ended 30 June 2010**	Half-year ended 31 December 2009	Half-year ended 30 June 2009
Net gain on fair value adjustments on investment properties	**601**	1,027	527
Deferred tax charge	**(99)**	(155)	(82)
Net gain on fair value adjustments on investment properties, after tax	**502**	872	445
Net gain on revaluation of premises	**1**	11	4
Deferred tax charge	**–**	(1)	(1)
Net gain on revaluation of premises, after tax	**1**	10	3

The aggregate impact of property revaluation before tax on the income statement in the first half of 2010 was a gain of HK$602 million, which arose mainly from a net gain of HK$601 million from the revaluation of investment properties and a net gain of HK$1 million from the revaluation of premises. The related deferred tax charge on revaluation of investment properties amounted to HK$99 million. As a result, the net impact of fair value adjustments on investment properties on the Group's profit attributable to equity holders in the first half of 2010 was a gain of HK$502 million.

Compared to the second half of 2009, the net gain on property revaluation in the first half of 2010 was milder, which was in line with the trend of property prices.

Financial Position

HK$'m, except percentage amounts	**At 30 June 2010**	At 31 December 2009
Cash and balances with banks and other financial institutions	**169,554**	160,788
Placements with banks and other financial institutions maturing between one and twelve months	**35,958**	60,282
Hong Kong SAR Government certificates of indebtedness	**41,950**	38,310
Securities investments[1]	**383,609**	358,349
Advances and other accounts	**597,306**	527,135
Fixed assets and investment properties	**37,558**	35,650
Other assets[2]	**36,241**	32,277
Total assets	**1,302,176**	1,212,791
Hong Kong SAR currency notes in circulation	**41,950**	38,310
Deposits and balances of banks and other financial institutions	**110,786**	99,647
Deposits from customers	**892,211**	842,321
Insurance contract liabilities	**35,050**	33,408
Other accounts and provisions[3]	**85,450**	66,694
Subordinated liabilities[4]	**27,192**	26,776
Total liabilities	**1,192,639**	1,107,156
Non-controlling interests	**2,826**	2,733
Capital and reserves attributable to the equity holders of the Company	**106,711**	102,902
Total liabilities and equity	**1,302,176**	1,212,791
Loan-to-deposit ratio[5]	**64.02%**	60.98%

1 Securities investments comprise investment in securities and financial assets at fair value through profit or loss.

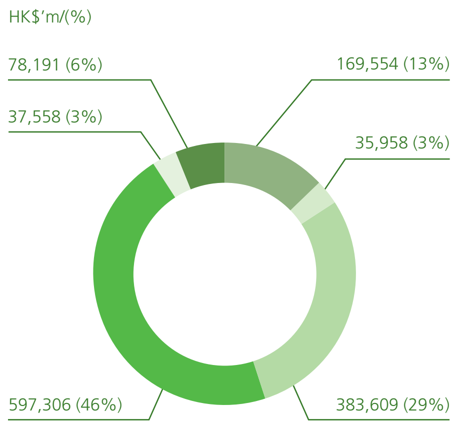
2 Interests in associates, deferred tax assets and derivative financial instruments are included in other assets.

3 Financial liabilities at fair value through profit or loss, derivative financial liabilities, current tax liabilities and deferred tax liabilities are included in other accounts and provisions.

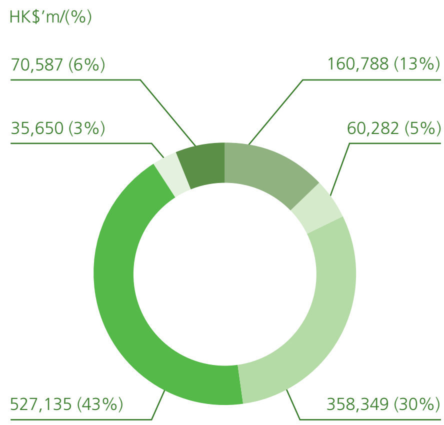
4 Subordinated liabilities as at 31 December 2009 represent USD and EUR subordinated loans granted by BOC (the "Loans"). During the first half of 2010, the Group issued USD subordinated notes (the "Notes"), the proceeds of which were applied to repay the USD Loans. Accordingly, subordinated liabilities as at 30 June 2010 comprise the Notes and the EUR Loans.

5 Of which deposits from customers also include structured deposits reported as "Financial liabilities at fair value through profit or loss".

Balance Sheet Mix as at 30 June 2010



Balance Sheet Mix as at 31 December 2009



- Cash and balances with banks and other financial institutions
- Placements with banks and other financial institutions maturing between one and twelve months
- Securities investments
- Advances and other accounts
- Fixed assets and investment properties
- Other assets

The Group's total assets were HK$1,302,176 million as at 30 June 2010, up HK$89,385 million or 7.4% from the end of 2009. The overall assets structure of the Group improved further with a growth in higher-yielding assets such as advances to customers as well as securities investments. Key changes include:

- Placements with banks and other financial institutions maturing between one and twelve months decreased by HK$24,324 million, or 40.4%, as the Group redeployed its funds for advances to customers and debt securities investments.
- Securities investments increased by HK$25,260 million or 7.0%. The Group expanded its investments in government-related securities, and high-quality financial institution bonds and corporate bonds.
- Advances and other accounts increased by HK$70,171 million, or 13.3%, which was mainly attributable to the growth in advances to customers by HK$56,514 million or 11.0%, and trade bills by HK$15,563 million or 171.0%.

In February and April 2010, the Group successfully completed the issue of Subordinated Notes (the "Notes") of US$1,600 million and US$900 million respectively to global debt investors. The proceeds of the Notes were used to repay the subordinated credit facility provided by BOC in December 2008. Pursuant to the regulatory requirements of the HKMA, the Notes qualify as Tier 2 Capital. The issue of the Notes broadened the Group's investor base and established a market benchmark for the Group to tap the debt market as an alternative source of future funding for its growth and development.

Advances to Customers

HK$'m, except percentage amounts	**At 30 June 2010**	**%**	At 31 December 2009	%
Loans for use in Hong Kong	**417,181**	**73.0**	381,394	74.1
Industrial, commercial and financial	**256,389**	**44.9**	224,261	43.6
Individuals	**160,792**	**28.1**	157,133	30.5
Trade finance	**39,285**	**6.9**	29,321	5.7
Loans for use outside Hong Kong	**115,020**	**20.1**	104,257	20.2
Total advances to customers	**571,486**	**100.0**	514,972	100.0

The Group continued to implement proactive business strategies and strengthened its collaboration with BOC to capture new business opportunities in the recovering economy. As a result, the Group's advances to customers grew by HK$56,514 million or 11.0% to HK$571,486 million as at 30 June 2010.

Loans for use in Hong Kong grew by HK$35,787 million or 9.4%.

- Lending to the industrial, commercial and financial sectors increased by HK$32,128 million, or 14.3%, to HK$256,389 million, covering a wide range of industries. Notable growth was recorded in the lending to property development, financial concerns, wholesale and retail trade as well as manufacturing industries.

- Residential mortgage loans (excluding those under the Government-sponsored Home Ownership Scheme) were up HK$4,283 million, or 3.4%, to HK$131,491 million. The proportion of total new drawdown in HIBOR-based residential mortgage loans showed a significant increase as customers inclined to take advantage of the low interbank rates.

Trade finance rose strongly by HK$9,964 million or 34.0%, which was in tandem with the growth in Hong Kong's merchandised trade in the first half of 2010. Meanwhile, loans for use outside Hong Kong grew by HK$10,763 million or 10.3%, which was driven by the increase in lending recorded by the Group's Mainland operation.

*Deposits from Customers**

HK$'m, except percentage amounts	**At 30 June 2010**	**%**	At 31 December 2009	%
Demand deposits and current accounts	**67,122**	**7.5**	65,440	7.7
Savings deposits	**473,492**	**53.0**	495,512	58.7
Time, call and notice deposits	**351,597**	**39.4**	281,369	33.3
	892,211	**99.9**	842,321	99.7
Structured deposits	**526**	**0.1**	2,132	0.3
Deposits from customers	**892,737**	**100.0**	844,453	100.0

* including structured deposits

In the first half of 2010, market competition for customer deposits was intense. Despite this, the Group's deposits from customers increased by HK$48,284 million, or 5.7%, to HK$892,737 million as a result of effective promotion strategies. The balance of time, call and notice deposits rose by HK$70,228 million or 25.0% to HK$351,597 million. Savings deposits recorded a drop of HK$22,020 million or 4.4%, while demand deposits and current accounts increased by HK$1,682 million, or 2.6%. Customers skewed their funds towards fixed deposits as the interest rates on fixed deposits were moving up gradually. Structured deposits, a hybrid of retail deposit and derivatives offering a higher nominal interest rate, dropped by HK$1,606 million, or 75.3%. The Group's loan-to-deposit ratio was up 3.04 percentage points to 64.02% at the end of June 2010.

Loan Quality

HK$'m, except percentage amounts	**At 30 June 2010**	At 31 December 2009
Advances to customers	**571,486**	514,972
Classified or impaired loan ratio[1]	**0.23%**	0.34%
Impairment allowances	**2,289**	2,269
Regulatory reserve for general banking risks	**4,611**	4,040
Total allowances and regulatory reserve	**6,900**	6,309
Total allowances as a percentage of advances to customers	**0.40%**	0.44%
Total allowances and regulatory reserve as a percentage of advances to customers	**1.21%**	1.23%
Impairment allowances[2] on classified or impaired loan ratio	**40.70%**	39.57%
Residential mortgage loans[3] – delinquency and rescheduled loan ratio[4]	**0.03%**	0.04%
Card advances – delinquency ratio[4,5]	**0.18%**	0.23%

	Half-year ended 30 June 2010	Half-year ended 30 June 2009
Card advances – charge-off ratio[5,6]	**1.56%**	3.14%

1 Classified or impaired loans represent advances which have been classified as "substandard", "doubtful" or "loss" under the Group's classification of loan quality, or individually assessed to be impaired.

2 Referring to impairment allowances on loans classified as "substandard", "doubtful" or "loss" under the Group's classification of loan quality, or individually assessed to be impaired.

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

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

5 Excluding Great Wall cards and computed according to the HKMA's definition.

6 Charge-off ratio is measured by a ratio of total write-offs made during the period to average card receivables during the period.

The Group's loan quality further improved with the classified or impaired loan ratio falling by 0.11 percentage point to 0.23%. Classified or impaired loans decreased by approximately HK$452 million, or 25.6%, to HK$1,317 million mainly due to collections and fewer new classified loans. New classified loans in the first half of 2010 represented approximately 0.03% of total loans outstanding.

Total impairment allowances, including both individual assessment and collective assessment, amounted to HK$2,289 million. Total impairment allowances in respect of the classified or impaired loans as a percentage of total classified or impaired loans accounted for 40.70%.

The quality of the Group's residential mortgage loans remained sound with the combined delinquency and rescheduled loan ratio standing at a low level of 0.03% at the end of June 2010. As compared to the first half of 2009, the charge-off ratio of card advances dropped by 1.58 percentage points to 1.56%, mainly due to the cardholders' improved debt servicing capability as economic conditions improved.

Capital and Liquidity Ratios

HK$'m, except percentage amounts	**At 30 June 2010**	At 31 December 2009
Core capital	**76,012**	72,465
Deductions	**(715)**	(334)
Core capital after deductions	**75,297**	72,131
Supplementary capital	**32,944**	32,638
Deductions	**(715)**	(334)
Supplementary capital after deductions	**32,229**	32,304
Total capital base after deductions	**107,526**	104,435
Risk-weighted assets		
Credit risk	**618,503**	578,374
Market risk	**18,501**	12,023
Operational risk	**47,898**	47,352
Deductions	**(20,126)**	(17,954)
Total risk-weighted assets	**664,776**	619,795
Capital adequacy ratios (consolidated basis)		
Core capital ratio	**11.33%**	11.64%
Capital adequacy ratio	**16.17%**	16.85%

	Half-year ended 30 June 2010	Half-year ended 30 June 2009
Average liquidity ratio	**37.81%**	39.70%

The Group adopted the Standardised Approach in calculating capital adequacy ratios.

Consolidated capital adequacy ratio of the banking group at 30 June 2010 was 16.17%, 0.68 percentage point lower than that at the end of 2009. The Group's total capital base expanded by 3.0% to HK$107,526 million mainly due to the increase in retained earnings. Meanwhile, risk-weighted assets for credit risk increased by 6.9% to HK$618,503 million, as a result of the growth in advances to customers.

The average liquidity ratio in the first half of 2010 remained strong at 37.81%.

BUSINESS REVIEW

PERSONAL BANKING

HK$'m, except percentage amounts	**Half-year ended 30 June 2010**	Half-year ended 30 June 2009	Increase/ (decrease)
Net interest income	**2,932**	2,849	+2.9%
Other operating income	**2,384**	2,218	+7.5%
Operating income	**5,316**	5,067	+4.9%
Operating expenses	**(3,044)**	(2,771)	+9.9%
Operating profit before impairment allowances	**2,272**	2,296	-1.0%
Net charge of loan impairment allowances	**(37)**	(74)	-50.0%
Others	**(5)**	(6)	-16.7%
Profit before taxation	**2,230**	2,216	+0.6%

	At 30 June 2010	At 31 December 2009	Increase/ (decrease)
Segment assets	**191,760**	178,026	+7.7%
Segment liabilities	**612,200**	570,566	+7.3%

Note: For additional segmental information, see Note 41 to the Interim Financial Information.

Financial Results

Personal Banking recorded a profit before taxation of HK$2,230 million in the first half of 2010. Operating income rose by 4.9%, driven by an increase in both net interest income and net fee income. Operating expenses rose by 9.9%. Operating profit before impairment allowances stood at HK$2,272 million.

Net interest income increased by 2.9% due to the growth in both the average interest-earning assets and customers deposits, as well as improved deposit mix. The increase was partly offset by narrower loan spread and deposit spread under the low interest rate environment. Other operating income rose by 7.5% on account of the strong growth in fee income from insurance and payment services. However, the increase was partially offset by the decline in fee income from stock brokerage.

Operating expenses rose by 9.9% mainly due to higher staff costs, rental expenses and IT costs.

Net charge of loan impairment allowances fell by HK$37 million or 50.0%, as customers' debt servicing capability improved with the economic recovery.

Advances and other accounts, including mortgage loans and card advances, increased by 9.3% to HK$177,488 million.

Business operation

In the first half of 2010, the Group solidified its premier position in RMB business and maintained its market leadership in residential mortgage business. It also continued to drive the development of its stock trading business. The Group expanded its customer base by extending its reach to high net-worth customers in the Mainland and other potential customer segments in Hong Kong. At the same time, its service platform was revamped to better meet customers' needs for investment services and traditional banking services.

Maintaining steady growth in residential mortgages

With the growth of the local property market in the first half of 2010, the Group achieved satisfactory results in the underwriting of new mortgages through effective marketing and the offering of a wide array of mortgage products. It continued to expand and strengthen its strategic partnership with major property developers and participated in joint promotions in most of the prime property development projects. In response to the launch of the "Sandwich Class Housing Scheme" by the Hong Kong Housing Society, the Group offered tailor-made mortgage plans to meet customers' needs. These initiatives helped maintain the Group's leading position in the underwriting of new mortgages. In recognition of its outstanding performance in the mortgage business, the Group received the "Sing Tao Excellent Services Brand Award 2009 – Mortgage Services" from Sing Tao Daily. By the end of June 2010, the Group's outstanding residential mortgage loans grew by 3.4% from the end of 2009. Meanwhile, the Group continued to strengthen its risk assessment and control over its mortgage business. The credit quality of residential mortgages remained sound with the delinquency and rescheduled loan ratio standing at a low level of 0.03% at the end of June 2010.

Promoting stock brokerage business and maintaining competitive edge in insurance

Overshadowed by the European debt crisis and the Mainland's tightening policy, sentiments in the stock market were weakened. This had an adverse impact on the Group's stock brokerage business. Despite this, the Group continued to enhance its products and services and focused on acquiring new customers. During the period, the Group launched a series of promotion and marketing campaigns and investment seminars in order to attract targeted customers. Meanwhile, the Group extended a bundled range of promotional offers to its stock-trading customers and embarked on a number of acquisition campaigns to attract new customers. The Group also introduced the "Big-Ticket Customer Programme" and "Incremental Turnover Usage Programme" for selected segments of existing customers to further expand its customer base and boost its stock brokerage business.

Regarding its Bancassurance business, the Group recorded significant sales growth by broadening its product spectrum, launching extensive marketing campaigns and implementing a multi-channel distribution strategy. The Group was the first in the Hong Kong market to launch RMB insurance products. It introduced RMB insurance products with settlement being made in Hong Kong Dollars, namely the "Target 8 Years Insurance Plan Series" and the "Target 5 Years Insurance Plan Series". These products offered greater flexibility to customers while capturing the capital gain potential from the appreciation of RMB. Meanwhile, the Group launched a life insurance savings plan, the "Glorious Life Savings Insurance Plan", and revamped existing insurance products to enhance the overall competitiveness in its product shelf. The Group continued to extend its financial planning model and rolled out large scale marketing campaigns to promote its customer oriented services. These initiatives helped expand its foothold in the market and boost the sales of insurance products significantly during the period.

Enhancing relationship with high net-worth customers

The Group strived to maintain long-term relationship with its wealth management customers by providing differentiated services and tailor-made wealth management solutions through different service channels. During the first half of 2010, the Group continued to strengthen its customer segmentation strategy and expand its high net-worth customer base. In order to further broaden its wealth management customer base, the Group launched the "Grow Your Wealth with Every Opportunity" campaign, "Wealth Management Customer Referral Programme" and "New Wealth Management Customer Loyalty Building Programme".

Besides, the Group introduced the Capital Investment Entrant Scheme ("CIES") Services promotion campaign to provide a wide range of banking services to CIES customers. It also continued to work closely with BOC in providing cross-border wealth management services. Meanwhile, a mobile sales team was established to enhance the collaboration with BOC branches and strengthened the business development of NCB (China). At the end of June 2010, the total number of wealth management customers and their assets maintained with the Group grew by 6.7% and 1.5% respectively from the end of 2009.

Steady growth in credit card business

The Group's card business sustained its growth momentum in the first half of 2010. The total number of cards issued increased by 9.3% compared to the end of 2009 while cardholder spending and merchant acquiring volume rose by 21.4% and 41.8% respectively year-on-year. The Group maintained its leadership in the China UnionPay ("CUP") merchant acquiring business and CUP card issuing business, with merchant acquiring and cardholder spending volume surging by 69.3% and 157.5% respectively compared to the first half of 2009.

Riding on the competitive edge of the "BOC CUP Dual Currency Credit Card" in the market, the Group continued to extend appealing merchant offer programmes to customers through its comprehensive merchant network covering Hong Kong, Macau and the Mainland.

The Group's success in credit card business gained extensive market recognition, as evidenced by a total of 28 awards received from VISA International, MasterCard and China UnionPay respectively.

The Group managed to safeguard its asset quality. The annualised charge-off ratio of credit cards for the six-month period to 30 June 2010 was 1.56%.

Maintaining market leadership in RMB banking business in Hong Kong

The Group remained the market leader in RMB banking business in Hong Kong. In the first half of 2010, the Group focused on the RMB integrated services, "RMB Remittance Express" and "RMB Exchange Express" and launched promotional offers to boost RMB deposits with satisfactory results. The Group also secured its leading position in the RMB card issuing business, with an increase of 45.5% in the number of RMB-HKD dual currency credit cards from the end of 2009. Meanwhile, the Group pioneered the first RMB life insurance product in Hong Kong with settlement being made in Hong Kong Dollars. This new product was well-received by customers. The Group also made significant progress in the RMB corporate banking business. For details, please refer to Corporate Banking section below.

Channel rationalisation and e-channel development

In response to the changing needs of customers, the Group revamped its branch network to strengthen its offering of investment services and traditional banking services. Customers can obtain specialised investment advices as well as comprehensive traditional banking services at designated branches. Service quality and customer experience were enhanced by a series of well-structured staff training programmes. At the end of June 2010, the Group's service network in Hong Kong comprised 269 branches.

The Group continued to enhance the functions of its e-Banking platform and improve its investment service quality. It introduced the credit card payment service for insurance premiums and remittance, which was the first of its kind in the market. At the same time, the launch of the new 24-hour scheduled electronic transfer functions provided customers with more efficient e-Banking services. It also strengthened the security measures such as a conversion to a new e-certificate storage device with higher security and notification of unusual transactions to customers by SMS. In the first half of 2010, the number of internet banking customer increased by 5.5% while stock trading transactions carried out through e-channels accounted for 77.1% of total transactions. The Group also enhanced the quality of telephone banking services by consolidating its services into four specialised hotline numbers, namely personal, corporate, investment and wealth management, with the aim of providing one-stop and more user-friendly phone banking services to customers. The Group also opened a new call centre in Shenzhen to provide cross-border service support for Hong Kong as well as Mainland customers.

To encourage more customers to use its automated banking services, the Group added new ATMs to its ATM network and increased the number of cheque deposit machines and cash deposit machines. At the same time, the Group enhanced its promotion of the dual currency cash withdrawal services, which aimed at providing convenient RMB cash withdrawal services to customers.

CORPORATE BANKING

HK$'m, except percentage amounts	**Half-year ended 30 June 2010**	Half-year ended 30 June 2009	Increase/ (decrease)
Net interest income	**2,995**	2,644	+13.3%
Other operating income	**1,464**	1,197	+22.3%
Operating income	**4,459**	3,841	+16.1%
Operating expenses	**(1,232)**	(1,039)	+18.6%
Operating profit before impairment allowances	**3,227**	2,802	+15.2%
Net release of loan impairment allowance	**131**	134	-2.2%
Others	**–**	(1)	–
Profit before taxation	**3,358**	2,935	+14.4%

	At 30 June 2010	At 31 December 2009	Increase/ (decrease)
Segment assets	**427,618**	372,443	+14.8%
Segment liabilities	**313,592**	304,882	+2.9%

Note: For additional segmental information, see Note 41 to the Interim Financial Information.

Financial Results

Corporate Banking performed particularly well with profit before taxation rising by HK$423 million or 14.4% to HK$3,358 million in the first half of 2010. Operating profit before impairment allowance increased by 15.2% to HK$3,227 million. The increase was mainly driven by the growth in net interest income and other operating income.

Net interest income increased by 13.3%, which was mainly attributable to the increase in the average balance of loans and advances. The increase was partly offset by narrower loan spread. Other operating income rose by 22.3%, primarily driven by the growth in fee income from the lending business, currency exchange and bills commission.

Operating expenses rose by 18.6% mainly due to higher staff costs, rental expenses and IT costs.

Advances and other accounts increased by 14.9% to HK$425,589 million.

Business Operation

The corporate banking business posted steady development during the first half of 2010. Corporate loans registered double-digit growth. The Group continued to provide comprehensive cross-border financing services for large corporate clients with overseas expansion plans. The Group succeeded in improving the pricing of new corporate loans during the period. Boosted by active marketing and product innovation, the Group stayed as the market leader in the cross-border RMB business in Hong Kong, pioneering a number of first transactions in new business areas. As for the Mainland business, the Group registered satisfactory growth in both loans and deposits.

Corporate loans sustained continuous growth

Against the backdrop of a reviving economy, the Group stepped up the provision and development of cross-border financial services for corporate clients in the Mainland using Hong Kong as a financial platform. As a result, corporate loans witnessed rapid growth. At the end of June 2010, the Group's overall corporate loans surged by 14.3% over the end of last year. It remained the top mandated arranger in the Hong Kong-Macau syndicated loan market.

Steady development of SME business

The Group gave further and active support to local enterprises with sound financial strength through the "SME Loan Guarantee Scheme" and "Special SME Loan Guarantee Scheme" launched by the government. In close collaboration with BOC and NCB (China) on the one hand, and by deepening cooperation with major trade associations on the other, the Group succeeded in reaching out to new customers. In recognition of its quality services and contribution to the SME business, the Group was honoured with the "SME's Best Partner Award" for the third consecutive year by the Hong Kong Chamber of Small and Medium Business Limited.

Pioneering new business areas in RMB banking

Leveraging its unique position as the Hong Kong's RMB clearing bank, the Group achieved a number of milestones in the development of the RMB banking business. Following the announcement of the "Elucidation of Supervisory Principles and Operational Arrangements Regarding Renminbi Business in Hong Kong" by the Hong Kong Monetary Authority on 11 February, the Group pioneered a number of first transactions in new areas of RMB business in Hong Kong, such as the granting of the first RMB export invoice finance, the first RMB import invoice finance, the first RMB working capital loan and the first RMB remittance service for dividend payout. In June 2010, the number of cities covered by the pilot programme of Cross-border RMB Trade Settlement Services was further expanded. BOCHK took the lead in conducting 34 cross-border RMB trade settlement transactions on the first day of the expanded pilot programme. In July 2010, the Group underwrote the first RMB corporate bond in Hong Kong as the sole bookrunner and lead manager.

The Group launched the CNY HIBOR as a pricing benchmark for RMB trade finance and commercial loans in Hong Kong. It also signed various agreements with more financial institutions across the globe for the provision of RMB clearing services. On 13 July, the People's Bank of China and BOCHK signed the "Agreement on Provision of Clearing Service for RMB Cashnotes Business for Taiwan" which authorises BOCHK as the Clearing Bank of RMB cashnotes business for Taiwan.

Trade finance registering strong growth

The Group's balance of trade finance surged notably by 34.0% over the end of 2009. This was partly fuelled by the rapid recovery in global trade and partly as a result of closer cooperation with BOC. Innovative products with cross-border features have been launched to enhance the Group's trade finance services. In April 2010, BOCHK received "The Asian Banker Achievement Award for Trade Finance in Hong Kong" from The Asian Banker magazine in recognition of its outstanding performance and contribution in trade finance.

Expanding foothold in custody services

Riding on its growth momentum in 2009, the custody business continued to flourish in the first half of 2010. The Group has successfully secured mandates to provide global custody services to various Qualified Domestic Institutional Investors, including major banks, fund houses and securities companies in the Mainland. Furthermore, with continuous communication and sales effort coupled with outstanding service track record, clients were increasingly aware of the Group's strengths and capabilities in the global custody arena. The Group continued to work closely with BOC to expand its customer base. At the end of June 2010, total assets under the Group's custody were valued at HK$384 billion.

Cash management making solid progress

The Group made solid progress in its cash management business in the first half of 2010. In April, the Group launched a remittance service via credit card, enabling BOCHK credit card holders to send remittance overseas with their BOCHK Credit Cards, which was the first of its kind in the market. A new Premium Savings Account product was launched in May, which provided competitive product features to corporate customers and attracted new savings deposits. The Group continued to strengthen the linkage of its cash management service platform with those of BOC and its overseas branches. With effective marketing, the remittance transaction volume increased by 14.0% year-on-year, while the number of Corporate Banking Services Online ("CBS Online") customers increase by 10.7% over the end of 2009.

Proactive measures in risk management

In view of the still uncertain global economic environment, the Group remained vigilant over risk management. To safeguard asset quality, the Group closely monitored those corporate customers which were adversely affected by rising production costs in the Mainland, RMB appreciation, the recent upsurge in commodity prices, and emerging risks in the Euro region. With a forward-looking credit control system in place, the Group was able to implement more stringent credit control in those segments with higher risks.

MAINLAND BUSINESS

Steady growth of Mainland business

The Group's Mainland business recorded satisfactory growth in the first half of 2010. Total operating income increased by 11.8% year-on-year, driven by a rapid growth in income which more than offset the increase in operating expenses following the Group's further investment in the Mainland. Total advances to customers grew by 18.2% over the end of 2009, while the deposits balance leaped by 60.6%. NCB (China) launched various RMB wealth management products, such as "Floating Yield Product with Flexible Maturity", "Yi An Investment-Supported Products" and "Structured Deposits Linked with Exchange Rate". The customer base was further enlarged, with considerable increase in the number of high net worth customers. Since the launch of debit cards in late 2009, the Group continued to enhance their features to provide more convenient financial services to cross-border customers. The Group's asset quality in the Mainland remained sound with the classified loan ratio dropping by 0.07 of a percentage point from the end of 2009 to 0.37%.

Further expansion of Mainland branch network

The Group's total number of branches and sub-branches in the Mainland was 23 at the end of June 2010. The expansion of the Group's network in the Mainland continued. During the first half of 2010, NCB (China) received approval from the China Banking Regulatory Commission ("CBRC") for establishing the Shanghai Hongqiao sub-branch and Beijing Zhongguancun sub-branch. Meanwhile, Wuxi branch of NCB (China) commenced business on 19 July 2010.

TREASURY

HK$'m, except percentage amounts	**Half-year ended 30 June 2010**	Half-year ended 30 June 2009	Increase/ (decrease)
Net interest income	**2,341**	2,999	-21.9%
Other operating income	**35**	747	-95.3%
Operating income	**2,376**	3,746	-36.6%
Operating expenses	**(330)**	(394)	-16.2%
Operating profit before impairment allowances	**2,046**	3,352	-39.0%
Net release/(charge) of impairment allowances on securities investments	**72**	(1,168)	+106.2%
Profit before taxation	**2,118**	2,184	-3.0%

	At 30 June 2010	At 31 December 2009	Increase/ (decrease)
Segment assets	**608,925**	593,807	+2.5%
Segment liabilities	**227,112**	195,956	+15.9%

Note: For additional segmental information, see Note 41 to the Interim Financial Information.

Financial Results

In the first half of 2010, the Treasury segment's profit before taxation fell by 3.0% to HK$2,118 million. Operating profit before impairment allowances decreased by 39.0% to HK$2,046 million, which was mainly caused by the decrease in net interest income and other operating income.

Net interest income fell by 21.9% mainly due to the decline in the average balance of residual funds as funds were redeployed for advances to customers. Meanwhile, the decrease in net yield of debt securities due to repricing also led to the decline in net interest income.

Other operating income dropped by 95.3% on account of the foreign exchange loss on foreign exchange swap contracts and mark-to-market loss on certain interest rate instruments.

Business Operation

Pursuing proactive investment strategy

In light of the gradual economic revival and uncertainties in capital markets, the Group proactively managed its banking book investments and adopted a prudent approach in asset and liability management. In the first quarter of 2010, the Group took advantage of the steepening yield curve and expanded its investments in fixed rate debt securities with increases in government-related securities as well as high quality financial institution bonds and corporate bonds in order to maximise the net interest margin of its investment portfolio. Starting from the second quarter, in spite of the sturdy growth in financial performance of financial institutions and corporations in the Asia-Pacific and the USA, credit spread widened as a result of the European sovereign debt crisis. While avoiding high-risk entities and regions, the Group seized the opportunity to increase its exposures to financial institution bonds and corporate bonds with robust fundamentals. Meanwhile, it also continued to provide clearing services to participating banks in Hong Kong and overseas regions.

As at the end of June 2010, the carrying value of the Group's exposure to US non-agency RMBS was HK$3.0 billion (versus HK$3.8 billion at the end of 2009). In respect of the exposure to the European countries which were affected by the debt crisis, namely Portugal, Ireland, Italy, Greece and Spain, the Group only had exposure to debt securities issued by financial institutions of Ireland and Italy amounting to a total of HK$1,806 million as at the end of June 2010 (versus HK$3,217 million at the end of 2009). There were no signs of impairment on these debt securities.

Focusing on traditional business and internal control

The European sovereign debt crisis had weakened market sentiments and investors' confidence. Despite this unfavorable factor, the Group's strategy of focusing on traditional products relating to foreign exchange and precious metals yielded promising results. Meanwhile, the Group also provided offshore customers with hedging products linked to foreign exchange and interest rate to meet their hedging needs. As a result, the trading volumes of RMB foreign exchange derivatives and interest rate swaps registered satisfactory growth. The Group also expanded business cooperation with BOC's overseas branches to conduct RMB exchange business. Meanwhile, the Group closely monitored and exercised stringent control on the sale procedures and risk of its structured products.

INSURANCE

HK$'m, except percentage amounts	**Half-year ended 30 June 2010**	Half-year ended 30 June 2009	Increase/ (decrease)
Net interest income	**724**	562	+28.8%
Other operating income	**3,361**	573	+486.6%
Operating income	**4,085**	1,135	+259.9%
Net insurance benefits and claims	**(3,875)**	(919)	+321.7%
Net operating income	**210**	216	-2.8%
Operating expenses	**(104)**	(61)	+70.5%
Profit before taxation	**106**	155	-31.6%

	At 30 June 2010	At 31 December 2009	Increase/ (decrease)
Segment assets	**40,153**	37,963	+5.8%
Segment liabilities	**37,459**	35,355	+6.0%

Note: For additional segmental information, see Note 41 to the Interim Financial Information.

Financial Results

The Group's Insurance segment recorded a profit before taxation of HK$106 million. The segment's profit dropped 31.6% year-on-year mainly due to the new business strain caused by the substantial increase in the regular premium business. This phenomenon is normal as new business, in particular the growth of regular premium, inevitably causes an immediate downward pressure on the current year's profit because higher commission expenses are recognised as incurred in the first year the policies are being written. The benefit of the new business to the Insurance segment's profit will be duly reflected in the years ahead.

Net interest income rose by 28.8% due to the increase in debt securities investments made for the new premiums received. Other operating income increased significantly by 486.6% due to the growth of net insurance premium income and a net gain on financial instruments designated at fair value through profit or loss. During the first half of 2010, net insurance premium income rose considerably by 23.6% year-on-year. Net gain on financial instruments designated at fair value through profit or loss was attributable to the mark-to-market gain of debt securities investment caused by the decrease in market interest rates. The change in market interest rates also led to a corresponding increase of net insurance benefits and claims.

The net insurance benefits and claims rose significantly following the increase in policy reserves caused by the growth of the insurance business and the decrease in interest rates.

Operating expenses increased by 70.5% which were primarily due to the increase in staff costs following the expansion of the financial planning team, and the increase in resources to strengthen the business support.

Assets in the insurance segment grew by 5.8% because of the increase in both debt and equity securities investments made for the new income. Liabilities rose by 6.0% reflected the corresponding increase in insurance contractual liabilities.

Business Operation

Further improvement in product mix and market share

Following the launch of the new financial planning team and "Need-based Selling" approach in 2009, the Group continued to make good progress in growing its insurance business. Total premium income increased with product mix improved. Regular premium received improved by 250.9% as the Group continued to emphasise on sale of regular-premium products.

Introducing new RMB insurance products

The Group intensified its effort in product innovation to fulfill customers' needs. In the first half of 2010, the Group introduced a broader range of RMB insurance products with settlement being made in Hong Kong Dollars. These new products, including the RMB "Target 8 Years Insurance Plan Series" and the RMB "Target 5 Years Insurance Plan Series", were highly receptive to customers. This reinforced the Group's leadership position in the RMB insurance business in Hong Kong.

RISK MANAGEMENT

Banking Group

Overview

The Group believes that sound risk management is crucial to the success of 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 credit risk, interest rate risk, market risk, liquidity risk, operational risk, reputation risk, legal and compliance risk, and strategic 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. It implements a comprehensive set of policies and procedures to identify, measure, monitor and control various risks that may arise. 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, is the highest decision-making authority of the Group and has the ultimate responsibility for risk management. The Board, with the assistance of its committees, has the primary responsibility for the formulation of risk management strategies and for ensuring that the Group has an effective risk management system to implement these strategies. The Risk Committee ("RC"), a standing committee established by the Board of Directors, is responsible for overseeing the Group's various types of risks, reviewing and approving high-level risk-related policies and overseeing their implementation, reviewing significant or high risk exposures or transactions and exercising its power of veto if it considers that any transaction should not proceed. The Audit Committee assists the Board in fulfilling its role in overseeing the internal control system.

The Chief Executive ("CE") is responsible for managing the Group's various types of risks, approving detailed risk management policies, and approving material risk exposures or transactions within his authority delegated by the Board of Directors. The Chief Risk Officer ("CRO") assists the CE in fulfilling his responsibilities for the day-to-day management of risks. The CRO is responsible for initiating new risk management strategies, projects and measures that will enable the Group to better monitor and manage new risk issues or areas that may arise from time to time from new businesses, products and changes in the operating environment. He may also take appropriate initiatives in response to regulatory changes. The CRO is also responsible for reviewing material risk exposures or transactions within his delegated authority and exercising his power of veto if he believes that any transaction should not proceed.

Various units of the Group have their respective risk management responsibilities. Business units act as the first line of defence while risk management units, which are independent from the business units, are responsible for the day-to-day management of different kinds of risks. Risk management units have the primary responsibilities for drafting, reviewing and updating various risk management policies and procedures.

The Group's principal banking subsidiaries, Nanyang, NCB (China) and Chiyu, are subject to risk policies that are consistent with those of the Group. These subsidiaries execute their risk management strategies independently and report to the Group's management on a regular basis.

Credit Risk Management

Credit risk is the risk that a customer or counterparty will be unable to or unwilling to meet its obligations under a contract. It arises principally from lending, trade finance and treasury businesses, and covers inter-bank transactions, foreign exchange and derivative transactions as well as investments in bonds and securities. The Chief Credit Officer reports directly to the CRO and is responsible for the management of credit risk and for the formulation of all credit policies and procedures. The Chief Analytics Officer who reports directly to the CRO is responsible for the development and maintenance of internal rating models and rating criteria. Different credit approval and control procedures are adopted according to the level of risk associated with the customer, counterparty or transaction. Corporate and financial institution credit applications are independently reviewed, objectively assessed and monitored by risk management units and credit rating models/scorecards are used in the process of credit approval whenever they are applicable. 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 the Group's credit and other functions is responsible for making an independent assessment of all credit facilities which require the approval of a Deputy Chief Executive or above.

The Group's internal loan grading system divides credit assets into 5 categories with reference to HKMA's guidelines. The Risk Management Department ("RMD") provides regular credit management information reports and ad hoc reports to the Management Committee, RC and Board of Directors to facilitate their continuous monitoring of credit risk.

For investments in debt securities and securitisation assets, the external credit rating and assessment on credit quality of the underlying assets are used for managing the credit risk involved. Credit limits are established on a customer and security issuer basis. For derivatives, the Group sets customer limits to manage the credit risk involved and follows the same approval and control processes as loans and advances. Ongoing monitoring procedures are established.

The Group adopts a comprehensive methodology in determining whether a particular asset/mortgage-backed security ("ABS/MBS") is impaired. Under the methodology, the Group will take into consideration not only the mark-to-market (MTM) price of the issue and its external credit rating, but also additional factors such as FICO score, vintage, location, adjustable rate mortgage ("ARM") status, delinquencies, level of collateral protection, loan to value ratio and prepayment speed of the underlying assets. Furthermore, having considered these factors, the ABS/MBS issue has to further pass the required credit enhancement coverage ratio set by the Group. This ratio is determined by applying assumptions regarding the default rates based on the available delinquency, foreclosure and real estate owned ("REO") data of the ABS/MBS issue.

Interest Rate Risk Management

The Group's interest rate risk exposures are mainly structural. The major types of interest rate risk from 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 the yield on assets and cost of liabilities may change by different amounts within the same repricing period

- Yield curve risk – non-parallel shifts in the yield curve, e.g. steepening or flattening of the yield curve that may have an adverse impact on net interest income or economic value

- Option risk – exercise of the options embedded in assets, liabilities or off-balance sheet items that can cause a change in the cashflows of assets and liabilities

The ALCO exercises its oversight of interest rate risk and ensures the business operations of the Group are conducted within the risk appetite and controls as set by RC. The Asset & Liability Management Department ("ALMD") assists the ALCO to manage and optimise the asset-liability structure of which the interest rate characteristics are key factors that affect the interest rate risk profile. RMD is the independent unit responsible for overseeing the interest rate risk according to the established policies and limits and reporting the results to RC and ALCO regularly.

The interest rate risk is identified and measured on a daily basis. 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. As the risk is complicated by having optionality embedded in certain products, behavioural assumptions are made to reflect more accurately the interest rate risk exposures. The key assumption in gap analysis includes the replacement of contractual maturity of fixed rate mortgage-backed (US prime and Alt-A) securities by behavioural maturity. 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 a hypothetical interest rate shock of 200 basis points across the yield curve on both sides. Earnings at Risk and Economic Value at Risk are controlled within an approved percentage of the projected net interest income for the year and the latest capital base respectively and these limits are sanctioned by RC. Moreover, sensitivity limits like PVBP and Option Greeks limits are adopted as daily control measures to monitor the repricing risk and option risk of the investment portfolio.

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. In addition, ratios of assets to liabilities with similar pricing basis are established to monitor such risk.

Apart from the above, regular stress tests and scenario analysis are conducted to assess the impact of different types of interest rate risk on the Group's earnings and economic value under both normal and stress conditions.

Before launching a new product or business, the relevant departments are required to go through a risk assessment process, which includes assessment of underlying interest rate risk and consideration of the adequacy of current risk management mechanism. Any material impact on interest rate risk noted during the risk assessment process will be reported to RC.

Market Risk Management

Market risk is the risk of loss that results from movements in market rates and prices. The Group's market risk in the trading book arises from customer-related business and proprietary trading. Trading positions are subject to daily mark-to-market valuation. The risk includes potential losses arising from a change in foreign exchange and interest rates as well as the prices of equities and commodities.

The major market risk in the banking book arises from the Group's investment portfolio. The risk includes potential losses arising from changes in market parameters such as credit, liquidity, and interest rate risk. These positions are subject to monthly mark-to-market valuation and various control measures in relevant risk areas.

Market risk management framework

Trading book market risk is managed within various major risk limits approved by the RC, including risk positions and/or risk factor sensitivities. Since April 2007, BOCHK has also formally applied Value-at-Risk (VAR) limit as a daily risk management tool. These overall risk limits are divided into sub-limits by reference to different risk products, including interest rates, foreign exchange rates, commodities and equities. Transactions are classified into different risk product categories according to the prominent type of risk inherent in the transactions.

As aforesaid, the Group's risk management objective is to enhance shareholder value by maintaining risk exposures within acceptable limits. The Group's market risk management framework comprises three levels. The Board of Directors is the ultimate decision-making authority. The formulation of risk management procedures and the implementation mechanism as well as the monitoring of compliance are mainly the responsibility of the Group's senior management (including CE and CRO). RMD is responsible for overseeing the Group's market risk to ensure that overall and individual market risks are within the Group's risk tolerance. Risk exposures are monitored on a day-to-day basis to ensure that they are within established risk limits and are regularly reported to the senior management. Nanyang, NCB (China), Chiyu and BOC Life have their own independent risk monitoring units to monitor limit compliance on a daily basis.

The Group controls market risk by restricting individual operations to trade only a list of permissible instruments authorised by the senior management and within various market risk limits approved by RC. The individual operations are also required to enforce rigorous new product approval procedures to ensure that all risks that may arise are thoroughly identified, properly measured and adequately controlled.

The Group also uses the VAR technique to measure potential losses and market risks of its trading book for reporting to the RC and senior management on a periodic basis. VAR is a statistical technique to estimate the potential losses that could occur on risk positions taken over a specified time horizon within a given level of confidence. BOCHK, being the banking entity within the Group with the major trading positions, which are mainly foreign currency and interest rate positions in major currencies, uses VAR technique to monitor and control market risk on a daily basis.

The Group uses backtesting to monitor the predictive power of the VAR measure. Backtesting compares the calculated VAR figure of those trading positions of each business day with the actual revenues arising on those positions on the next business day. These actual revenues exclude non-trading income, such as fee and commission. If backtesting revenues are negative and exceeding the VAR, a "backtesting exception" is noted. The Group will assess the magnitude of the backtesting exceptions, and revise its VAR model (including the parameters and assumptions) accordingly. Backtesting results are reported to the Group's senior management, including CE and CRO.

Although a valuable guide to risk, VAR should always be viewed in the context of its limitations. For example:

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a one-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

The Group recognises these limitations by augmenting its VAR limits with other position and sensitivity limit structures. Additionally, the Group applies a wide range of stress testing, both on individual portfolios and on the Group's consolidated positions. The stress testing programme of the trading book includes sensitivity testing on changes in risk factors with various degrees of severity as well as scenario analyses on historical events, including the 1987 Equity Market Crash, the 1994 Bond Market Crash, the 1997 Asian Financial Crisis, the 11 September 2001 event in the United States and the 2008 Financial Market Crisis. The Group's stress-testing regime provides senior management with an assessment of the financial impact of identified extreme events on the market risk exposures of the Group.

Liquidity Risk Management

The aim of liquidity management is to enable the Group to meet, even under adverse market conditions, all its maturing repayment obligations on time, and to fund all its asset growth and strategic opportunities with reasonable costs.

The primary objective of the Group's asset and liability management strategy is to achieve optimal returns while ensuring adequate levels of liquidity and capital within an effective risk control framework. The Group funds its operations principally by accepting deposits from retail and corporate depositors. In addition, the Group may issue certificates of deposit or debt instruments to secure long-term funds. Besides, the Group may obtain funds from the interbank market when necessary. 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.

Liquidity management is carried out at both the Group and the subsidiary level. BOCHK and its subsidiaries are required to maintain a strong daily liquidity position and a healthy cash flow profile that can align the risk-taking incentives with the liquidity exposures and make sure all funding obligations are met when due. Subsidiaries are required to report their respective liquidity position to BOCHK on a regular basis to facilitate group-wide management.

The ALCO exercises its oversight of liquidity risk and ensures the daily operations of the Group are conducted within the risk appetite and controls as set by RC. ALMD assists the ALCO to manage and optimise the asset-liability structure of which the maturity profile is a key factor that affects the liquidity risk profile. RMD is the independent unit responsible for overseeing the liquidity risk according to the established policies and limits on a daily basis and reports the results to RC and ALCO regularly.

Liquidity risk management tools adopted include cash flow analysis (under normal and stress conditions), such as Maximum Cumulative Outflow, liquidity buffer asset portfolio, and balance sheet management ratios, deposits maturity structure, concentration risk, liquidity ratio, loan-to-deposit ratio, etc. Apart from these, regular stress tests (bank-specific crisis and general-market crisis) and scenario analysis are conducted to assess the Group's capability to withstand various severe liquidity crises.

Before launching a new product or business, the relevant departments are required to go through a risk assessment process, which includes the assessment of underlying liquidity risk and consideration of the adequacy of the current risk management mechanism. Any material impact on liquidity risk noted during the risk assessment process will be reported to RC.

Operational Risk Management

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. The risk is inherent in every aspect of business operations and confronted by the Bank in its day to day operational activities.

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 authorisation is the fundamental principle followed by the Group. Corporate-level policies and procedures on operational risk management are formulated by Operational Risk & Compliance Department ("OR&CD") and approved by RC.

The Group has adopted the "Three Lines of Defence" model for its operational risk management framework. All departments and business units are the first line of defence, responsible for managing and reporting operational risks specific to their business/functional areas by applying the respective tools such as key risk indicators, self assessment and operational risk events reporting mechanism to identify, assess and control the risks inherent in their business/functional processes, activities and products. OR&CD together with certain operational risk-related functional departments within the Group are the second line of defence. In addition to formulating the operational risk management policies and procedures, OR&CD is also responsible for developing and introducing operational risk management tools, monitoring the performance and result of operational risk management in various units, assessing operational risk profile, recording operational risk data and reporting operational risk events to RC and the senior management in order to assist the overall management of the Group's operational risk. Certain functional departments including the Human Resources Department, Informational Technology Department, Corporate Services Department, Financial Management Department, General Accounting & Accounting Policy Department and OR&CD, are required to carry out the corporate-level operational risk management for the risk areas that are under their functional responsibilities and to provide other units with professional advice/training in respect of certain operational risk categories. The Audit

Department is the third line of defence, responsible for conducting independent audit of the operational risk management activities to evaluate their compliance and effectiveness.

The Group also takes out insurance to mitigate unforeseeable operational risks. Business continuity plans are in place to support business operations in the event of an emergency or disaster. Adequate backup facilities are maintained and periodic drills are conducted.

Reputation Risk Management

Reputation risk is the risk that negative publicity regarding the Group's business practices, whether genuine or not, will cause a potential decline in the customer base or lead to costly litigation or revenue erosion. Reputation risk is inherent in every aspect of business operation and covers a wide spectrum of issues.

In order to mitigate reputation risk, the Group has formulated and duly followed its Reputation Risk Management Policy. The policy aims to prevent and manage reputation risk proactively at an early stage when an incident occurs. The system entails continuous monitoring of external reputation risk incidents and published failures of risk incidents in the financial industry.

In the Lehman Brothers minibonds incident, the Group has handled customer complaints in accordance with regulatory guidelines and completed the repurchase of most of the outstanding minibonds under the Repurchase Scheme and its complaint handling process to minimise the reputation risk.

Legal and Compliance Risk Management

Legal risk is the risk that unenforceable contracts, lawsuits or adverse judgments may disrupt or otherwise negatively affect the operation or financial condition of the Group. Compliance risk is the risk of legal or regulatory sanctions, financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with all applicable laws and regulations. Legal and compliance risks are managed by the OR&CD headed by a General Manager who reports to the CRO.

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 Board of Directors reviews and approves the policy for the management of strategic risks. Key strategic issues have to be fully evaluated and properly endorsed by the senior management and the Board.

The Group will regularly review its business strategies to cope with the latest market situation and developments.

Capital Management

The major objective of capital management is to maximise shareholders' total return while maintaining a capital adequacy position commensurate with the Group's overall risk profile. The Group periodically reviews its capital structure and adjusts the capital mix where appropriate. ALCO monitors the Group's capital adequacy position. The Group has complied with all the statutory capital standards for all the periods in the first half of 2010.

To comply with HKMA's requirements as stated in the Supervisory Policy Manual "Supervisory Review Process", the Group has established the internal capital adequacy assessment process (ICAAP) and reviews it annually. Using the statutory minimum CAR, 8%, as a starting point, extra capital (capital add-on) needed to cover the risks not captured under Pillar I is assessed. A Scorecard approach based on HKMA's compliance guidance on Pillar II has been used to evaluate the Group's risk profile in order to assess the add-on capital in Pillar II to the minimum regulatory capital calculated under Pillar I to determine the minimum CAR. An Operating CAR Range has also been established which incorporates the need for future business growth and efficiency of capital utilisation. In view of the envisaged adoption of Foundation internal ratings-based approach ("FIRB"), the minimum CAR and the Operating CAR Range for 2010 are determined based on both Standardised approach and FIRB approach.

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 by various risk management units and ALCO monitors the results against limits approved by RC. The Financial Management Department reports the combined stress test results to the Board and RC regularly.

BOC Life Insurance

The principal activity of BOC Life's business is the underwriting of long-term insurance business in life and annuity, unit-linked long-term business and retirement scheme management in Hong Kong. Major types of risk arising from the BOC Life's insurance business are insurance risk, interest rate risk, liquidity risk, market risk and credit risk. BOC Life closely monitors these risks independently and reports to its RC on a regular basis. The key risks of its insurance business and related risk control processes are as follows:

Insurance Risk Management

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 the application of its underwriting policies and reinsurance arrangement.

The underwriting strategy is intended to set premium pricing at an appropriate level that corresponds to 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 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, BOC Life has a retention limit on any single life insured. BOC Life cedes the excess of the insured benefit over the limit for standard risks (from a medical point of view) to reinsurer under an excess of loss reinsurance arrangement.

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 and persistency. 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 Management

An increase in interest rates may result in the depreciation of the value of the bond portfolio. It may also result in customers accelerating surrenders. A decrease in interest rates may result in an inability to adequately match guarantees or lower returns leading to customer dissatisfaction. BOC Life manages the asset liability matching of its portfolios within an asset liability management framework that has been developed to achieve investment returns that match its obligations under insurance contracts.

Liquidity Risk Management

Liquidity risk is the risk of not being able to fund increases in assets or meet obligations as they fall due without incurring unacceptable loss. BOC Life's asset liability matching framework includes cash flow management to preserve liquidity to match policy payout from time to time. In the normal course of BOC Life's business, new business premiums generate constant cash inflows and, as a result, the portfolios also grow gradually to meet future liquidity requirement.

Credit Risk Management

BOC Life has exposure to credit risk, which is the risk that a customer or counterparty will be unable to or unwilling to meet a commitment that it has entered into. Key areas to which BOC Life's insurance business is exposed include:

- Default risk of bond issuers or the counterparties of structured products
- Credit spread widening as a result of credit migration (downgrade)
- Re-insurers' 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 manages credit risk by placing limits on its exposure to each investment counterparty or group of counterparties. Such limits are subject to annual or more frequent review by the management.

In order to enhance credit risk management, BOC Life has strengthened its communication with the Investment Management of the Group and closely monitors and updates the established Disposal and Watch Lists to ensure consistency with the Group's credit risk management and investment strategy.