CROSS-BORDER
Corporate Banking Service


DEPOSITS/CREDIT SERVICES
CONSOLIDATED STATEMENT
RMB
SERVICES
ZHEJIANG · CHONGQING · TIANJIN · SHANGHAI · BEIJING · GUANGDON

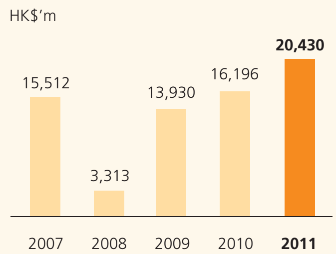
MANAGEMENT'S DISCUSSION AND ANALYSIS

FINANCIAL PERFORMANCE AND CONDITION IN BRIEF

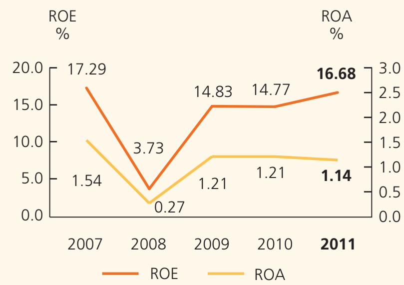
Capitalising on its core competencies, the Group achieved encouraging financial results in 2011. Profit attributable to the equity holders reached a record high. Financial ratios and risk indicators remained solid.

Key Performance Trends

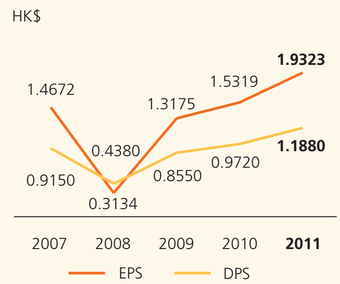
Profit Attributable to the Equity Holders



Return on Average Shareholders' Equity[1] ("ROE") and Return on Average Total Assets[2] ("ROA")



Earnings Per Share ("EPS") and Dividend Per Share ("DPS")



Profit attributable to the equity holders reaching new high

- Profit attributable to the equity holders increased by 26.1% to HK$20,430 million, part of the growth was attributable to the positive impact of Lehman Brothers-related products[3]. Should this impact be excluded, it would have increased by 11.5% year-on-year to HK$18,148 million, a record high since listing.

Solid return with sustainable growth

- ROE was 16.68%. Excluding the impact of Lehman Brothers-related products, ROE would have been 14.55%, up 0.15 percentage point year-on-year.
- ROA was 1.14%. Excluding the impact of Lehman Brothers-related products, ROA would have been 1.01%, down 0.20 percentage point year-on-year. The decrease was due to the diluting effect of RMB clearing business in Hong Kong and the lower average return on the Group's other assets.

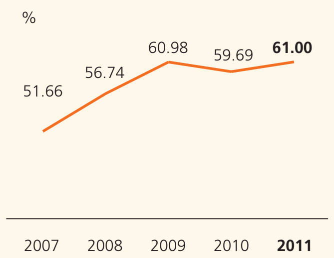
Continuous growth of return to shareholders

- EPS rose to a record high of HK$1.9323. DPS was HK$1.188, increasing by 22.2% year-on-year.

MANAGEMENT'S DISCUSSION AND ANALYSIS

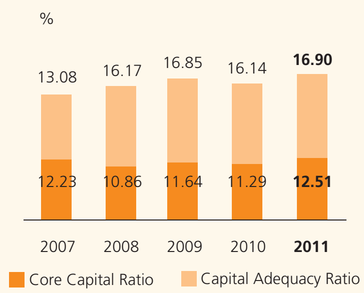
Financial Position

Loan-to-Deposit Ratio[4]



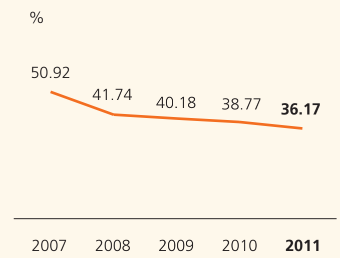
* as at 31 December

Capital Adequacy Ratio[5]



* as at 31 December

Average Liquidity Ratio



Well-balanced deposit and loan growth

- Advances to customers increased healthily by 14.1% while deposits from customers rose by 11.6%. Loan-to-deposit ratio was at 61.00%.

Solid capital base to support business growth

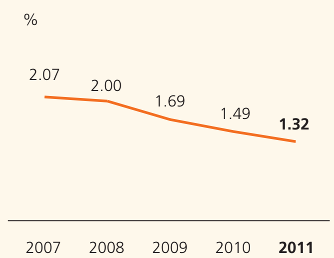
- CAR was strong at 16.90%, while core capital ratio stood at 12.51%.

Sound liquidity position

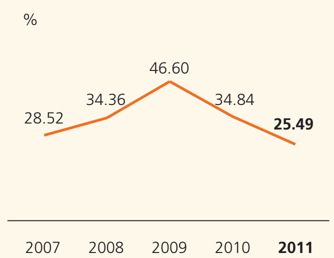
- Average liquidity ratio remained sound at 36.17%.

Key Operating Ratios

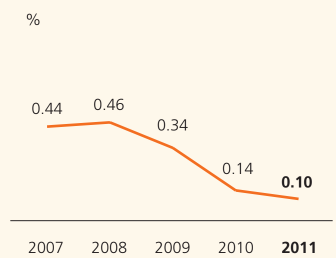
Net Interest Margin ("NIM")



Cost-to-Income Ratio



Classified or Impaired Loan Ratio[6]



* as at 31 December

NIM rebounded in the second half of the year

- NIM for the year was 1.32%, down 17 basis points year-on-year due to persistently low market interest rates, the diluting effect of RMB business in Hong Kong and rising funding costs. Meanwhile, NIM for the second half of the year was 1.44%, up 23 basis points from the first half.

Effective cost control

- Cost-to-income ratio was 25.49%. Should the impact of Lehman Brothers-related products be excluded, it would have been 34.56%, one of the lowest in the industry.

Low classified or impaired loan ratio under stringent risk management

- Classified or impaired loan ratio was 0.10%. Formation of new classified loans remained at a low level.

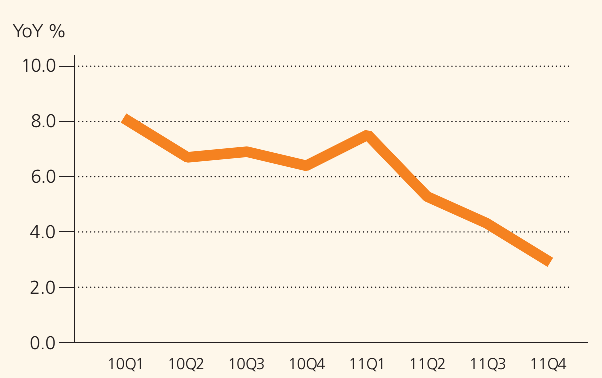
1. Return on Average Shareholders' Equity as defined in "Financial Highlights".
2. Return on Average Total Assets as defined in "Financial Highlights".
3. The final resolution of certain series of Lehman Brothers Minibonds was announced on 15 June 2011. The net amount of HK$2,854 million recovered by the Group from the underlying collateral of the Lehman Brothers Minibonds, after deducting the ex gratia payments and provision for trustee expenses, was credited to operating expenses in 2011. The net recovery together with the expenses of Lehman Brothers-related products is referred to as "impact of Lehman Brothers-related products" in the Management's Discussion and Analysis.
4. The deposit base also includes structured deposits reported as "Financial liabilities at fair value through profit or loss".
5. Capital adequacy ratio is computed on the consolidated basis that comprises the positions of BOCHK and certain subsidiaries specified by the HKMA for its regulatory purposes and in accordance with the Banking (Capital) Rules. The bases of regulatory capital calculation for credit risk, market risk and operational risk are described in Note 4.5 to the Financial Statements in this Annual Report. As a result of the change in the bases used, the capital ratios shown above are not directly comparable.
6. Classified or impaired loans follow the definitions set out in the Banking (Disclosure) Rules under the Banking Ordinance and represent advances which are either classified as "substandard", "doubtful" or "loss" under the Group's classification of loan quality, or individually assessed to be impaired.

MANAGEMENT'S DISCUSSION AND ANALYSIS

ECONOMIC BACKGROUND AND OPERATING ENVIRONMENT

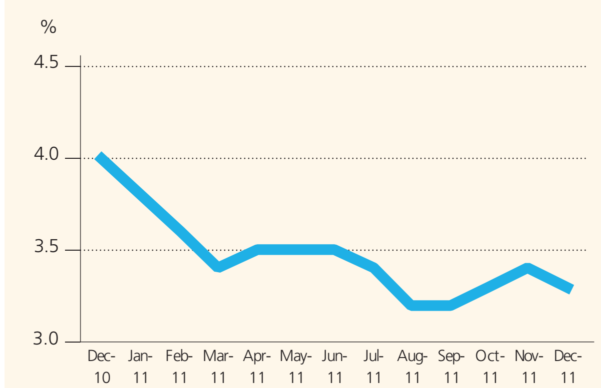
The global economic environment was highly volatile during 2011, posing major challenges to the banking industry as a whole. There was an increased degree of uncertainty in the market as a result of various incidents and crises, including the earthquake and nuclear crisis in Japan, the downgrade of the US sovereign credit rating and the aggravation of the European debt crisis. The US continued with unconventional monetary easing measures to stimulate the economy while EU countries struggled to contain the spreading of the sovereign debt crisis from peripheral to core countries. Back in Asia, the Mainland of China remained the main engine of economic growth with its GDP growing by 9.2%. However, the Mainland's inflationary pressure also intensified during the year, which necessitated the implementation of contractionary monetary policies such as the raising of both the reserve requirement ratio and benchmark interest rates.

Hong Kong Real GDP



Source: HKSAR Census and Statistics Department

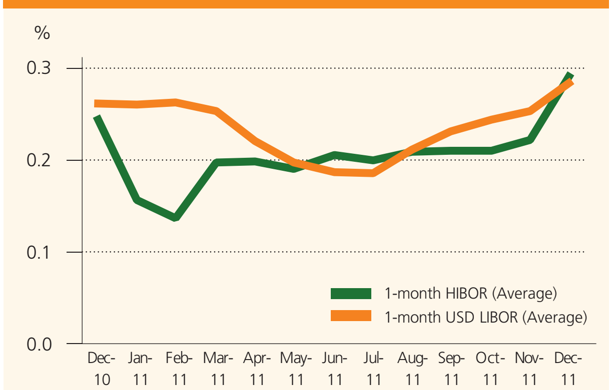
Hong Kong Unemployment Rate



Source: HKSAR Census and Statistics Department

The Hong Kong economy continued to grow in 2011 though with a slower pace since the second quarter of the year. Supported by private consumption and fixed investment, Hong Kong's GDP for the year 2011 increased by 5.0% year-on-year. The unemployment rate stayed at a low level. Inflationary pressure was mounting, with the Composite CPI rising by 5.7% year-on-year in December 2011.

HIBOR and USD LIBOR



Source: Bloomberg

Interbank interest rates stayed low after the second round of quantitative easing in the US. Average 1-month HIBOR and USD LIBOR increased only slightly from 0.24% and 0.26% in December 2010 to 0.29% and 0.28% respectively in December 2011.

The Hong Kong stock market was volatile during the year. Market sentiments turned weak because of the uncertain global economic outlook, the worsening of the European debt crisis as well as the tightening of the Mainland's monetary policy. The Hang Seng Index reached the lowest point of the year at 16,250 in October, closing at 18,434 at the end of 2011, down 20.0% on a yearly basis.

The local residential property market was buoyant in the first half but had cooled down since the second half of the year, reflecting the combined impact of the weaker global growth outlook, rising mortgage interest rates, and various stabilising measures imposed by the Hong Kong government. The transaction volume of residential units plunged and prices fell modestly in the second half of the year.

The offshore RMB market in Hong Kong expanded further with several major breakthroughs. The demand for RMB trade settlement grew rapidly. Both RMB loans and deposits in Hong Kong saw remarkable growth. Foreign investors were permitted to invest directly in the Mainland with offshore RMB funds. Offshore monetary authorities and eligible banks began to participate in the Mainland's interbank bond market. With regard to the RMB clearing bank business in Hong Kong, a major development was the introduction of the RMB Fiduciary Account Service to help participating banks better manage their credit exposure to the clearing bank.

In summary, the operating environment for the banking industry was very challenging in 2011. Persistently low interest rates continued to put pressure on banks' net interest income. Funding costs were higher as competition for deposits remained intense. The inflation of operating costs also adversely affected banks' profitability. Nevertheless, the banking sector in general was able to benefit from business opportunities arising from the strong demand for corporate loans and the further expansion of the offshore RMB market in Hong Kong.

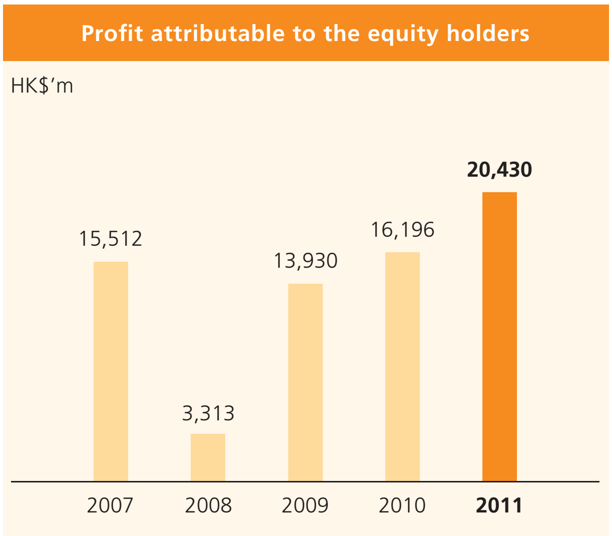
Outlook for 2012

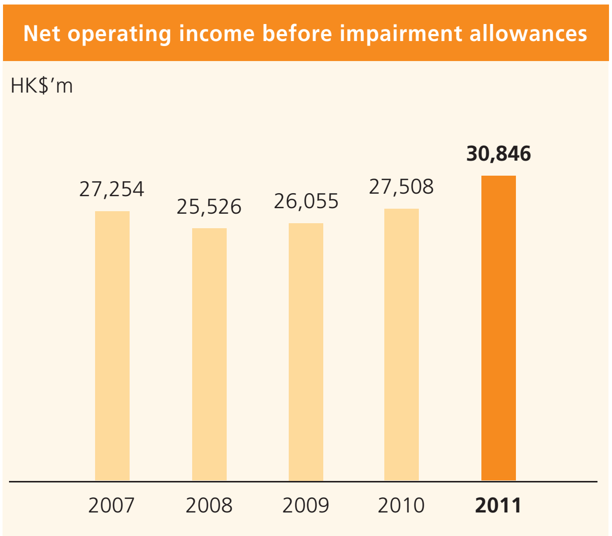
The external economic environment is likely to stay unstable in the coming year. The European debt crisis would continue to have a negative impact on the global financial market and lead to rising systemic risk. Given the weak economic outlook, the monetary policies of advanced economies would remain accommodative. The possibility of an economic slowdown would be a major risk facing the Mainland in the coming year. Some banks might face de-leveraging pressure in view of new capital adequacy requirements.

The demand for RMB loans in Hong Kong has picked up speed in the second half of 2011. The offshore RMB bond market would probably develop with greater momentum. RMB Foreign Direct Investment and RMB Qualified Foreign Institutional Investors would provide new channels for the deployment of RMB funds. Offshore RMB-related services are therefore expected to be the focus of the banking sector in 2012.

CONSOLIDATED FINANCIAL REVIEW

Financial Highlights





HK$'m	2011	2010
Net operating income before impairment allowances	**30,846**	27,508
Operating expenses	**(7,862)**	(9,584)
Operating profit before impairment allowances	**22,984**	17,924
Operating profit after impairment allowances	**22,478**	18,239
Profit before taxation	**24,680**	19,742
Profit attributable to the equity holders of the Company	**20,430**	16,196

The Group's net operating income before impairment allowances increased by HK$3,338 million or 12.1% year-on-year to HK$30,846 million, a record high. This achievement was made possible by the solid growth of its traditional businesses and the better deployment of RMB funds. The increase in income was broad-based, covering net interest income, net fee and commission income as well as net trading gain from foreign exchange. There was, however, an investment loss on certain financial instruments due to higher volatility in the market. Operating expenses decreased sharply, primarily due to the net recovery from the underlying collateral of the Lehman Brothers Minibonds. The Group recorded a moderate amount of net charge of impairment allowances. The net gain on property revaluation also rose year-on-year. Profit attributable to the equity holders of the Company rose by 26.1% compared to 2010.

As compared to the first half of 2011, the Group's net operating income before impairment allowances rose by 3.9% in the second half. Higher net interest income was the main driver. Profit attributable to the equity holders decreased by HK$3,556 million or 29.7% as the net recovery from the underlying collateral of the Lehman Brothers Minibonds was recorded in the first half. The decrease was also attributable to higher impairment allowances and lower net gain on property revaluation in the second half of the year.

Factors Affecting the Group's Performance in 2011

Below are the key positive factors that contributed to the Group's 2011 financial performance:

- The Group maintained ***healthy growth in both loans and deposits*** with improved loan pricing. This helped support the growth of net interest income and the development of other banking businesses.
- Net fee and commission income on ***traditional banking businesses*** recorded double-digit growth.
- The Group made good progress in developing its ***RMB business in Hong Kong***. There was an increase in the channels of RMB deployment, which contributed to the rise in profit.
- The Group further improved its service capabilities and focused on ***operational efficiency***.
- There was a ***net recovery of HK$2,854 million from the underlying collateral*** of the Lehman Brothers Minibonds in the first half of 2011.

The Group's financial performance in 2011 was also subject to the following key negative factors:

- The exceptionally low market interest rates continued to impose pressure on the Group's ***asset yield***. Intense market competition for deposits in both Hong Kong and the Mainland also led to higher ***funding costs***.
- ***Investment loss on certain financial instruments*** was recorded in the second half of the year due to increased volatilities in the market.

INCOME STATEMENT ANALYSIS

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	**2011**	2010
Interest income	**31,931**	23,449
Interest expense	**(9,952)**	(4,715)
Net interest income	**21,979**	18,734
Average interest-earning assets	**1,662,201**	1,255,879
Net interest spread	**1.24%**	1.43%
Net interest margin#	**1.32%**	1.49%
Adjusted net interest margin* (adjusted for clearing bank function)	**1.49%**	1.59%

Net interest margin is calculated by dividing net interest income by average interest-earning assets.

* The adjusted net interest margin excludes the estimated impact of RMB clearing services performed by BOCHK. Since December 2003, the Bank has been appointed as the clearing bank to provide RMB clearing services in Hong Kong.

Net interest income was up HK$3,245 million or 17.3% year-on-year. The growth was driven by the increase in average interest-earning assets. Average interest-earning assets grew by HK$406,322 million or 32.4%, supported by the Group's customer deposits and the increase in RMB funds from the clearing bank business. Net interest margin was 1.32%, down 17 basis points compared to 2010. Net interest spread declined by 19 basis points while contribution from net free fund rose by 2 basis points.

The decrease in net interest margin was mainly due to the growth of local RMB business which had a lower spread than that of non-RMB business. Should the estimated impact of BOCHK's RMB clearing function in Hong Kong be excluded, the adjusted net interest margin would have been 1.49%, down 10 basis points year-on-year. Rising deposit costs amid keen market competition also put pressure on the interest spread. On the asset side, the increased proportion of loans and advances with pricing based on interbank market rates dragged the level of asset yield as the market rates remained low.

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

ASSETS	Year ended 31 December 2011 Average balance HK$'m	Year ended 31 December 2011 Average yield %	Year ended 31 December 2010 Average balance HK$'m	Year ended 31 December 2010 Average yield %
Balances and placements with banks and other financial institutions	**571,705**	**1.48%**	276,827	1.07%
Debt securities investments	**420,154**	**2.35%**	393,865	2.24%
Loans and advances to customers	**654,802**	**2.04%**	570,697	2.01%
Other interest-earning assets	**15,540**	**1.50%**	14,490	1.37%
Total interest-earning assets	**1,662,201**	**1.92%**	1,255,879	1.87%
Non interest-earning assets	**161,788**	**–**	126,242	–
Total assets	**1,823,989**	**1.75%**	1,382,121	1.70%

LIABILITIES	Year ended 31 December 2011 Average balance HK$'m	Year ended 31 December 2011 Average rate %	Year ended 31 December 2010 Average balance HK$'m	Year ended 31 December 2010 Average rate %
Deposits and balances from banks and other financial institutions	**378,841**	**0.77%**	142,969	0.76%
Current, savings and fixed deposits	**1,023,278**	**0.61%**	859,366	0.34%
Subordinated liabilities	**27,800**	**2.02%**	27,113	1.88%
Other interest-bearing liabilities	**39,403**	**0.50%**	53,949	0.33%
Total interest-bearing liabilities	**1,469,322**	**0.68%**	1,083,397	0.44%
Non interest-bearing deposits	**69,877**	**–**	67,037	–
Shareholders' funds# and non interest-bearing liabilities	**284,790**	**–**	231,687	–
Total liabilities	**1,823,989**	**0.55%**	1,382,121	0.34%

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

Second Half Performance

Compared to the first half of 2011, net interest income rose by HK$1,569 million or 15.4% to HK$11,774 million. The increase was mainly attributable to higher net interest margin.

Average interest-earning assets dropped by 4.3% compared to the first half of the year. The drop was mainly caused by the decrease in participating banks' deposit balance with the clearing bank. Following the launch of the RMB fiduciary account scheme in April, participating banks might choose to place their RMB funds in the fiduciary account which will not be included in the Group's balance sheet. Participating banks might also reduce their deposits with the clearing bank as the use of offshore RMB funds further expanded in the latter half of the year.

Net interest margin was 1.44%, up 23 basis points half-on-half. Should the estimated impact of BOCHK's RMB clearing function in Hong Kong be excluded, the adjusted net interest margin would have been 1.51%, up 3 basis points. The diluting effect of the Group's RMB clearing bank business on net interest margin eased as the balance declined. The Group increased the deployment of its RMB funds to higher-yielding assets such as RMB loans and advances, interbank placements as well as bonds. Meanwhile, the pricing of its corporate and residential mortgage loans further improved, but rising deposit costs continued to compress net interest spread.

Net Fee and Commission Income

HK$'m	2011	2010
Credit cards business	**2,887**	2,222
Securities brokerage	**2,782**	3,338
Loan commissions	**1,160**	961
Insurance	**1,097**	561
Bills commissions	**854**	751
Payment services	**637**	568
Trust and custody services	**379**	249
Funds distribution	**337**	160
Safe deposit box	**211**	200
Currency exchange	**156**	113
Others	**358**	356
Fee and commission income	**10,858**	9,479
Fee and commission expenses	**(3,025)**	(2,435)
Net fee and commission income	**7,833**	7,044

Net fee and commission income increased by HK$789 million, or 11.2%, to HK$7,833 million. The growth was broad-based. Fee income from credit cards grew by 29.9%, driven by the increase of 20.6% and 34.1% respectively in cardholder spending and merchant acquiring volume. Commission income from insurance, comprising life insurance, general insurance and reinsurance, grew by 95.5%, with the rise in business volume. Loan commissions and bills commissions grew by 20.7% and 13.7% respectively. The Group leveraged its marketing efforts and enhanced its services through the investment product specialist team. As a result, commission from funds distribution rose substantially by 110.6%. Fee and commission income from trust and custody services, payment services and currency exchange also registered satisfactory growth. Meanwhile, income from securities brokerage was down 16.7% under a weak market environment. Fee and commission expenses increased by HK$590 million or 24.2%, mainly due to higher expenses of the credit card and insurance businesses.

Second Half Performance

Compared to the first half of 2011, net fee and commission income dropped by HK$139 million or 3.5% in the second half. There was growth in the fee income from traditional businesses such as credit cards, trust and custody services, payment services and bills commissions. However, fee income from securities brokerage and insurance commission income declined as market sentiments weakened.

Net Trading Gain/(Loss)

HK$'m	2011	2010
Foreign exchange and foreign exchange products	**1,430**	999
Interest rate instruments and items under fair value hedge	**12**	262
Equity instruments	**82**	(8)
Commodities	**186**	116
Net trading gain	**1,710**	1,369

Net trading gain was HK$1,710 million, up HK$341 million or 24.9% year-on-year. Benefiting from the fast-growing currency exchange activities and a reduction in foreign exchange loss on foreign exchange swap contracts*, the Group grew its net trading gain from foreign exchange and related products by HK$431 million or 43.1%. Net trading gain from interest rate instruments and items under fair value hedge dropped by HK$250 million or 95.4%, mainly reflecting mark-to-market losses on certain interest rate instruments versus gains in the previous year. The increase in trading gain from commodities was driven by the growth in bullion transactions.

Second Half Performance

Compared to the first half of 2011, net trading gain increased by HK$188 million or 24.7%. This was mainly due to a lower foreign exchange loss on foreign exchange swap contracts and increased contribution from bullion transactions.

* 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 gain/(loss)"), while the corresponding interest differential between the surplus funds in original currency and swapped currency is reflected in net interest income.

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

HK$'m	**2011**	2010
Banking business of the Group*	**(1)**	44
BOC Life	**(339)**	698
Net (loss)/gain on financial instruments designated at fair value through profit or loss	**(340)**	742

* The amount in 2011 was after group consolidation elimination.

The Group recorded a net loss of HK$340 million on financial instruments designated at FVTPL in 2011, compared to a net gain recorded in the previous year. The net loss in 2011 was mainly due to the loss from the investment portfolio of BOC Life amid the weak financial market.

Second Half Performance

Net loss on financial instruments designated at FVTPL in the second half of the year was HK$738 million, versus a gain of HK$398 million recorded in the first half of 2011. The loss recorded in the second half of the year was mainly attributable to the BOC Life's investment portfolio.

Operating Expenses

HK$'m	**2011**	2010
Staff costs	**6,038**	5,357
Premises and equipment expenses (excluding depreciation)	**1,390**	1,201
Depreciation on owned fixed assets	**1,277**	1,131
Other operating expenses	**1,954**	1,806
Core operating expenses	**10,659**	9,495
Impact of Lehman Brothers-related products*	**(2,797)**	89
Total operating expenses	**7,862**	9,584

	At 31 December 2011	At 31 December 2010
Staff headcount measured in full-time equivalents	**14,475**	13,806

* The final resolution of certain series of Lehman Brothers Minibonds was announced on 15 June 2011. The net amount of HK$2,854 million recovered by the Group from the underlying collateral of the Lehman Brothers Minibonds, after deducting the ex gratia payments and provision for trustee expenses, was credited to operating expenses in 2011.

Total operating expenses decreased by HK$1,722 million, or 18.0%, to HK$7,862 million, mainly resulting from the net recovery of HK$2,854 million from the underlying collateral of the Lehman Brothers Minibonds in 2011. Core operating expenses rose by HK$1,164 million, or 12.3%, reflecting the Group's continued investments to support long-term business growth while maintaining disciplined cost control. Additional expenses were incurred for business expansion in strategic focus areas such as the Mainland operation.

Staff costs increased by 12.7%, mainly due to higher salaries as a result of annual salary increment, increase in headcount and performance-related remuneration.

Premises and equipment expenses rose by 15.7% with higher rental for the branches in Hong Kong and the Mainland as well as higher IT costs. Depreciation on owned fixed assets rose by 12.9% due to larger depreciation charge on premises following the upward property revaluation in Hong Kong.

Other operating expenses were up by 8.2% mainly due to higher expenses connected with the increased business volume.

Compared to the end of 2010, headcount measured in full-time equivalents rose by 669, mostly from the front-line staff. Headcount for the Mainland business also increased as a result of the expansion of NCB (China).

Second Half Performance
Compared to the first half of 2011, operating expenses rose by HK$3,876 million. Excluding the impact of Lehman Brothers-related products, core operating expenses increased by HK$1,003 million or 20.8%. The increase was due to higher staff cost, promotion, IT and rental expenses in the second half of the year.

Net (Charge)/Reversal of Loan Impairment Allowances

HK$'m	**2011**	2010
Net (charge)/reversal of allowances before recoveries		
– individual assessment	**(12)**	149
– collective assessment	**(720)**	(528)
Recoveries	**353**	449
Net (charge)/reversal of loan impairment allowance	**(379)**	70

A net charge of loan impairment allowances of HK$379 million was recorded in 2011 versus a net reversal of HK$70 million in 2010. There was a modest amount of HK$12 million in the net charge of individually assessed impairment allowances in 2011 compared to a reversal of HK$149 million in 2010. The higher net charge of collectively assessed impairment allowances was primarily due to loan growth and the periodic review of the parameter values in the assessment model.

Second Half Performance
A net charge of loan impairment allowances amounting to HK$342 million was recorded in the second half of 2011, up HK$305 million from the first half. The increase was mainly caused by a higher net charge of collectively assessed impairment allowances, as a result of the periodic review of the parameter values in the assessment model and lower recoveries in the second half of the year.

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

HK$'m	**2011**	2010
Held-to-maturity securities	**(124)**	46
Available-for-sale securities	**7**	208
Net (charge)/reversal of impairment allowances on securities investments	**(117)**	254

A net charge of impairment allowances on securities investments of HK$117 million was recorded in 2011 compared to a net reversal of HK$254 million in 2010. The net charge of impairment allowances in 2011 included a net charge of HK$161 million (2010: HK$56 million) made against debt securities issued by financial institutions of Ireland and Italy, which were subsequently disposed of during the second half.

Second Half Performance
A net charge of impairment allowances on securities investments amounting to HK$129 million was registered in the second half of 2011, versus a net reversal of HK$12 million in the first half. The net charge in the second half was mainly made against debt securities issued by financial institutions of Italy.

BALANCE SHEET ANALYSIS

Asset Deployment

	At 31 December 2011		At 31 December 2010	
HK$'m, except percentage amounts	Amount	% of total	Amount	% of total
Cash and balances with banks and other financial institutions	**278,795**	**16.0%**	415,812	25.0%
Placements with banks and other financial institutions maturing between one and twelve months	**107,910**	**6.2%**	39,499	2.4%
Hong Kong SAR Government certificates of indebtedness	**65,890**	**3.8%**	46,990	2.8%
Securities investments[1]	**425,600**	**24.5%**	430,060	25.9%
Advances and other accounts	**755,229**	**43.5%**	645,424	38.9%
Fixed assets and investment properties	**52,091**	**3.0%**	41,391	2.5%
Other assets[2]	**52,995**	**3.0%**	41,864	2.5%
Total assets	**1,738,510**	**100.0%**	1,661,040	100.0%

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.

In 2011, the Group managed its assets and liabilities proactively and focused on optimising asset allocation. It maintained a balanced growth in both deposits from customers and advances to customers. Particular emphasis was made in securing time deposits and quality lending. Funds were redeployed to higher yielding assets such as advances to customers, RMB interbank placements and RMB bonds. As at 31 December 2011, the Group's total assets amounted to HK$1,738,510 million, increasing by HK$77,470 million or 4.7% from the end of 2010.

Key changes in the Group's total assets include:

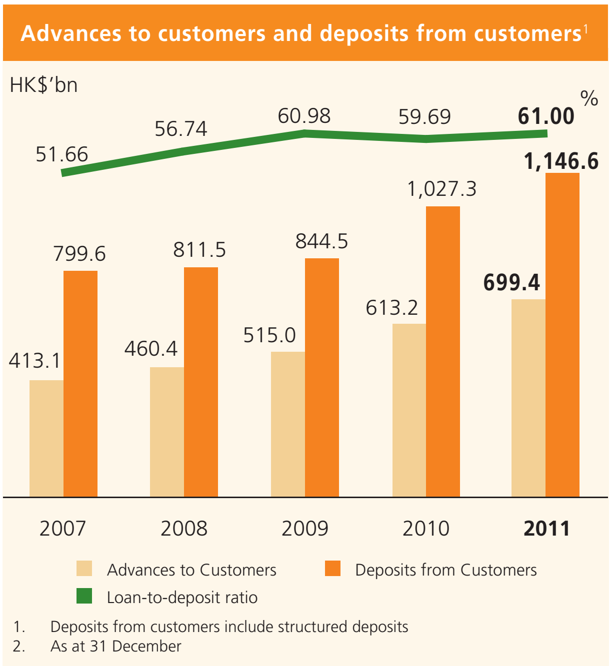
- Cash and balances with banks and other financial institutions decreased by 33.0%, mainly due to the decline in RMB funds placed with the People's Bank of China ("PBOC") by BOCHK's clearing business as RMB funds from participating banks to the clearing bank decreased.

- Placements with banks and other financial institutions maturing between one and twelve months increased by 173.2%, mainly due to growth in placements relating to the RMB business in Hong Kong.

- Securities investments decreased by 1.0% as the Group proactively reduced its exposure to European countries and lower-yielding securities to improve its portfolio mix. Meanwhile, the Group increased its holdings in higher-yielding RMB-denominated securities.

- Advances and other accounts rose by 17.0%, which was mainly attributable to the growth in advances to customers by 14.1% and trade bills by 78.8%.

- Other assets grew by 26.6%, which was mainly led by the increase in derivative financial instruments and reinsurance assets.



Advances to Customers

HK$'m, except percentage amounts	At 31 December 2011		At 31 December 2010	
	Amount	**% of total**	Amount	% of total
Loans for use in Hong Kong	**444,540**	**63.6%**	387,087	63.1%
Industrial, commercial and financial	**237,557**	**34.0%**	206,947	33.7%
Individuals	**206,983**	**29.6%**	180,140	29.4%
Trade finance	**59,508**	**8.5%**	53,396	8.7%
Loans for use outside Hong Kong	**195,331**	**27.9%**	172,736	28.2%
Total advances to customers	**699,379**	**100.0%**	613,219	100.0%

The Group continued to optimise its loan portfolio structure and focus on quality and profitability. There was a healthy loan growth of HK$86,160 million or 14.1% to HK$699,379 million in 2011 with improved pricing on new corporate loans and residential mortgages.

Loans for use in Hong Kong grew by HK$57,453 million or 14.8%.

- Lending to the industrial, commercial and financial sectors increased by HK$30,610 million, or 14.8%, to HK$237,557 million, covering a wide range of industries. Loans to the wholesale and retail trade sector grew strongly by 34.8%, benefiting from vibrant retail sales as a result of strong local consumption demand. Lending to the manufacturing, property investment and transport and transport equipment sectors also grew by 14.7%, 8.4% and 13.3% respectively.

- Lending to individuals increased by HK$26,843 million, or 14.9%. Owing to the buoyant property market, particularly in the first half of the year, residential mortgage loans (excluding those under the Government-sponsored Home Ownership Scheme) grew by 15.2%. Credit card advances increased by 17.3%, supported by the 12.4% rise in the number of cards issued and the 20.6% increase in cardholder spending volume. Other loans to individuals rose strongly by 35.8%.

Trade finance rose by HK$6,112 million, or 11.4%. Meanwhile, loans for use outside Hong Kong grew by HK$22,595 million or 13.1%, mainly driven by strong Mainland-related credit demand. The Group remained highly vigilant in risk management and selective in credit approval.

Second Half Performance

Loan growth slowed down in the second half of the year as the Group maintained stringent risk control in view of the worsening outlook and the slowing down of the local economy. Total advances to customers increased by HK$26,521 million or 3.9%, mainly driven by the growth in loans for use outside Hong Kong and lending to the industrial, commercial and financial sectors.

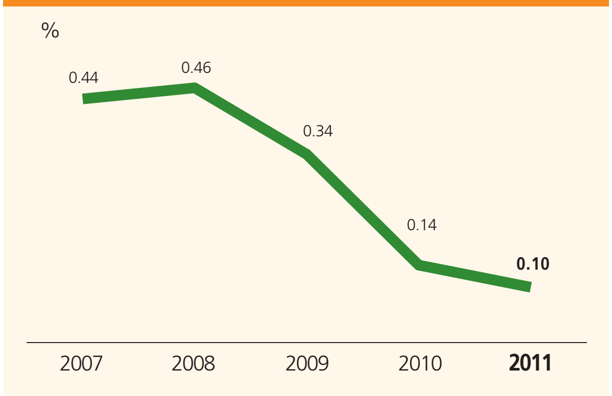
Loan Quality

HK$'m, except percentage amounts	**At 31 December 2011**	At 31 December 2010
Advances to customers	**699,379**	613,219
Classified or impaired loan ratio[1]	**0.10%**	0.14%
Impairment allowances	**2,830**	2,311
Regulatory reserve for general banking risks	**6,967**	5,076
Total allowances and regulatory reserve	**9,797**	7,387
Total allowances as a percentage of advances to customers	**0.40%**	0.38%
Impairment allowances[2] on classified or impaired loan ratio	**39.86%**	40.02%
Residential mortgage loans[3] – delinquency and rescheduled loan ratio[4]	**0.01%**	0.02%
Card advances – delinquency ratio[4,5]	**0.16%**	0.15%

	2011	2010
Card advances – charge-off ratio[5,6]	**1.07%**	1.36%

1. Classified or impaired loans follow the definitions set out in the Banking (Disclosure) Rules under the Banking Ordinance and represent advances which are either 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 year to average card receivables during the year.

Classified or impaired loan ratio



* as at 31 December

The Group's loan quality remained sound. The classified or impaired loan ratio dropped by 0.04 percentage point to 0.10% – one of the lowest in the industry. Classified or impaired loans decreased by HK$157 million, or 18.1%, to HK$710 million mainly due to collections. Formation of new classified loans in 2011 remained at a low level and represented approximately 0.07% of total loans outstanding.

Total impairment allowances, including both individual assessment and collective assessment, amounted to HK$2,830 million. Total impairment allowances on classified or impaired loans as a percentage of total classified or impaired loans was at 39.86%.

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 0.01% at the end of 2011. As compared to 2010, the charge-off ratio of card advances dropped by 0.29 percentage point to 1.07%, mainly due to cardholders' improved debt servicing capability.

Deposits from Customers*

HK$'m, except percentage amounts	At 31 December 2011 Amount	At 31 December 2011 % of total	At 31 December 2010 Amount	At 31 December 2010 % of total
Demand deposits and current accounts	**77,440**	**6.7%**	70,453	6.9%
Savings deposits	**504,868**	**44.0%**	528,035	51.4%
Time, call and notice deposits	**563,643**	**49.2%**	428,545	41.7%
	1,145,951	**99.9%**	1,027,033	100.0%
Structured deposits	**639**	**0.1%**	234	0.0%
Deposits from customers	**1,146,590**	**100.0%**	1,027,267	100.0%

* Including structured deposits.

The Group adopted a flexible deposit strategy to support business growth. In spite of fierce competition, the Group enlarged its deposit base by HK$119,323 million, or 11.6% to HK$1,146,590 million. A series of measures were taken to optimise the deposit mix to maintain a stable deposit growth. These included innovative promotion campaigns and the offering of various deposit products. Demand deposits and current accounts increased by 9.9% while time, call and notice deposits rose by 31.5%. Savings deposits recorded a drop of 4.4%. The Group's loan-to-deposit ratio was 61.00% at the end of 2011, up 1.31 percentage points.

Second Half Performance
Total deposits from customers increased by HK$42,586 million or 3.9% in the second half of 2011. Demand deposits and current accounts increased by 9.7%. Time, call and notice deposits rose by 10.6%. Savings deposits decreased by 3.5%.

Senior Notes

As part of the Group's proactive measures in asset and liability management, BOCHK issued US$750 million worth of senior notes to professional and institutional investors under the Medium Term Note Programme in November 2011. The outstanding of senior notes was shown as *Debt securities in issue at amortised cost* on the balance sheet.

Subordinated Liabilities

The outstanding subordinated liabilities comprised floating-rate subordinated loans obtained from BOC in 2008 and fixed-rate subordinated notes issued by BOCHK in 2010. Both subordinated liabilities were qualified as Tier 2 capital of BOCHK, which helped the Group better manage its capital structure.

Capital and Reserves Attributable to the Equity Holders of the Company

HK$'m	At 31 December 2011	At 31 December 2010
Share capital	**52,864**	52,864
Premises revaluation reserve	**23,150**	15,750
Reserve for fair value changes of available-for-sale securities	**1,787**	2,629
Regulatory reserve	**6,967**	5,076
Translation reserve	**674**	453
Retained earnings	**44,323**	38,409
Reserves	**76,901**	62,317
Capital and reserves attributable to the Equity Holders of the Company	**129,765**	115,181

Capital and reserves attributable to the equity holders grew by HK$14,584 million, or 12.7% to HK$129,765 million at 31 December 2011. Retained earnings increased by 15.4%, reflecting the 2011 profit after the appropriation of dividends. Premises revaluation reserve increased by 47.0%, which was attributable to the increase in property prices in 2011. Increases in the carrying amount arising on revaluation of premises are credited to the premises revaluation reserve while any increase in the fair value of investment properties is reported directly in the income statement. Regulatory reserve rose by 37.3% due to loan growth and the higher reserve ratio requirement. Reserve for fair value changes of available-for-sale securities was down 32.0%, reflecting the drop in fair value of available-for-sale debt securities, mainly due to the widening of credit spread.

Capital and Liquidity Ratio

HK$'m, except percentage amounts	**At 31 December 2011**	At 31 December 2010
Core capital after deductions	**84,600**	77,943
Supplementary capital after deductions	**29,654**	33,544
Total capital base after deductions	**114,254**	111,487
Total risk-weighted assets	**676,024**	690,597
Capital adequacy ratios (consolidated basis)		
Core capital ratio	**12.51%**	11.29%
Capital adequacy ratio	**16.90%**	16.14%

	2011	2010
Average liquidity ratio	**36.17%**	38.77%

In prior years, the Group adopted the standardised (credit risk) ("STC") approach and the standardised (market risk) ("STM") approach to calculate credit risk capital charge and market risk capital charge respectively.

With the HKMA approval from 1 January 2011, the Group has migrated to the foundation internal ratings-based ("FIRB") approach to calculate the credit risk capital charge for the majority of its non-securitisation exposures and internal ratings-based (securitisation) approach to calculate the credit risk capital charge for its securitisation exposures. A small residual credit exposures was approved by HKMA to be exempted from FIRB approach and remained under STC approach.

BOCHK has adopted the internal models approach to calculate general market risk capital charge for foreign exchange and interest rate exposures as at 31 December 2011, while the remaining of the Group continued to adopt the STM approach to calculate the market risk capital charge.

The Group continues to adopt the standardised (operational risk) ("STO") approach to calculate the minimum capital charge for operational risk in year 2011.

Consolidated capital adequacy ratio at 31 December 2011 was 16.90%. As a result of the change in the bases of regulatory capital calculation, the amounts shown above are not directly comparable.

The average liquidity ratio in 2011 remained strong at 36.17%.

MANAGEMENT'S DISCUSSION AND ANALYSIS

BUSINESS REVIEW

2011 Business Highlights

Personal Banking

- Maintained its leading position in residential mortgages
- Boosted the sales of funds by 122.7% through the enhancement of the sales model and professionalism
- The credit card business achieved robust growth with credit card advances rising strongly by 17.3%
- Customer base for wealth management rose by 17.4%
- Received the "Best Internet Banking" and "Best Mobile Telephone Banking" awards under the Capital Weekly Service Awards 2011

Corporate Banking

- Registered a healthy growth of 13.5% in corporate loans with improved pricing on new loans
- Remained the top mandated arranger in the Hong Kong-Macau syndicated loan market
- Launched innovative cash management products, enlarged the customer base, and increased the number of CBS Online customers by 26.8%
- Expanded the client base for custody service
- Received the "SME's Best Partner Award" for the fourth consecutive year

Treasury

- Proactively improved the portfolio mix by reducing the exposure to European countries and lower-yielding securities in view of rising market volatilities
- Adjusted asset allocation and portfolio duration to enhance liquidity

Insurance

- Maintained its leading market position in the life insurance business
- Further improved the product mix and grew gross regular premium income by 56.4%
- The financial planning team was highly effective in boosting the sales of insurance products

Mainland Business

- Strengthened the deposit base and ensured that the loan-to-deposit ratio was in compliance with the regulatory requirement
- Improved the asset mix and loan pricing to counteract the negative impact from rising funding costs
- The branch network expanded to a total of 27 at end-2011 with the addition of two new sub-branches
- Enhanced the linkage of the Group's service platform with that of BOC to enable debit card holders to access services through BOC's network

RMB Business in Hong Kong

- Maintained the leading position in RMB banking business, including deposits taking, trade settlement, credit card and insurance
- Reappointed by the PBOC as the clearing bank for RMB business in Hong Kong
- Introduced securities trading & payment services, trade finance, and cash management products; two own-branded RMB bond funds were launched
- Developed a global RMB banknote network with BOC's overseas branches
- Introduced the RMB Fiduciary Account Scheme and RMB Repo facilities

MANAGEMENT'S DISCUSSION AND ANALYSIS

2012 Business Focuses

The external economic environment, in particular the global financial market, will continue to be uncertain. In view of that, while capitalising on its core competencies to implement growth strategies, the Group will also be highly alert in safeguarding its assets and investments by means of stringent risk management and control.

With offshore RMB business being one of the key strategic focuses, the Group will step up its effort in growing the business and enhancing its RMB banking service capabilities. It will also work closely with BOC to explore cross-border financial needs and pursue business opportunities from Mainland enterprises seeking global expansion.

The Group will continue with its focus on customer segmentation and market penetration. The service model for high-net-worth customers will be further enhanced to upgrade its service quality and boost wealth management-related businesses.

In the Mainland, the Group will optimise its distribution channels and focus on the development of an integrated cross-border financial service platform by cooperating closely with BOC.

Business Segment Performance

HK$'m, except percentage amounts	Personal Banking	Corporate Banking	Treasury	Insurance	Others[1]	Consolidated
2011						
Profit before taxation	**4,896**	**8,636**	**6,515**	**33**	**4,600**	**24,680**
% of total	**19.8%**	**35.0%**	**26.4%**	**0.1%**	**18.7%**	**100.0%**
2010						
Profit before taxation	4,656	6,961	5,463	505	2,157	19,742
% of total	23.6%	35.3%	27.7%	2.5%	10.9%	100.0%

1. Profit before taxation of Others in 2011 included the net recovery from the underlying collateral of the Lehman Brothers Minibonds.
2. For additional segmental information, see Note 49 to the Financial Statements.

PERSONAL BANKING

Financial Results

Personal Banking recorded a profit before taxation of HK$4,896 million.

Net interest income decreased by 3.7%. There was growth in average loans and advances but the loan and deposit spread became narrower with more intense competition. Personal loans and customer deposits increased by 15.4% and 1.3% respectively from last year end.

Net fee and commission income decreased by 3.0%. This was mainly due to the lower commission income from securities brokerage. There was satisfactory growth in fee income from insurance and funds distribution, thanks to the contribution of the Group's professional sale teams. Net trading gain rose by 17.8%, which was mainly led by the mark-to-market gain from equity instruments.

Business operation

The Group made good progress in growing its Personal Banking business in 2011. Customer deposits and the residential mortgage business experienced solid growth and maintained their respective leading positions in the market. The fund distribution and life insurance businesses also performed strongly. The credit card business continued to grow and captured a larger market share. The range of RMB products was further widened with the launch of new RMB credit cards as well as investment and insurance products.

Residential mortgages – 15.2% growth

Thanks to the buoyant residential property market, particularly in the first half of 2011, the Group grew its residential mortgage loans by 15.2% from the end of 2010. The pricing on new residential mortgage loans was adjusted upward according to the market condition, while both HIBOR and Prime-based mortgages were provided in response to customers' demand. The Group also successfully offered the Reverse Mortgage Programme launched by The Hong Kong Mortgage Corporation Limited and achieved a leading market share. The Group worked in close partnership with major property developers and participated in the joint promotions of most of the prime property development projects.

Investment and insurance businesses – robust growth in the sales of funds and insurance products

The Group expanded its stock brokerage service spectrum, including its mobile trading platform, to reinforce its strong position in personal securities business. The trading system was enhanced with the launch of RMB-denominated securities trading services. These helped pave the way for the development of RMB-denominated securities business in Hong Kong. In the fund distribution business, the Group rolled out new products and tailor-made services to high-end customers. Two own-branded private funds, namely BOCHK RMB Bond Fund and BOCHK RMB High Yield Bond Fund were introduced to targeted customers. The Investment Product Specialist Team provided customers with professional service on investment products. As a result, commission income from fund distribution surged by 110.6%.

Regarding its Bancassurance business, the Group strengthened its position as a prominent life insurance provider and maintained its lead in the RMB insurance market. In view of the increasing demand for RMB products, a new flagship product – the "RMB Universal Life Insurance Plan" – was launched and met with keen response from customers. The Group further enhanced its financial planning model and cross-selling capabilities with encouraging results.

Credit card business – growth of merchant acquiring and cardholder spending outpacing the market

The Group's credit card business saw robust growth in 2011 with a gain in market share. It maintained its leadership in the China UnionPay ("CUP") merchant acquiring business and card issuing business. The "BOC CUP Dual Currency Commercial Card" was launched with enthusiastic response from corporate customers. A number of co-branded cards were also issued to attract new quality cardholders. Customer incentive programmes were offered to segmented cardholders for promoting loyalty and boosting cardholder spending. As a result, the total number of cards issued increased by 12.4% while the merchant acquiring and cardholder spending volumes surged by 34.1% and 20.6% respectively. Credit card advances rose by 17.3%.

Wealth management customers – increasing by 17.4% from end of 2010

The Group continued to offer differentiated services and customised wealth management solutions to foster long-term relationship with wealth management customers. Through the Capital Investment Entrant Scheme and in collaboration with BOC branches and NCB (China), the Group was able to attract a larger number of high-net-worth customers in Hong Kong and the Mainland. The total number of wealth management customers grew by 17.4% year-on-year. The Group also further optimised its Investment Product Specialist Team for servicing the high net-worth customer group.

Distribution channels – enhancing e-channels to offer seamless customer service

The Group continued to optimise its distribution channels to meet the needs of both local and cross-border customers. At the end of 2011, the Group's service network in Hong Kong comprised 266 branches, including 133 wealth management centres and 21 dedicated Mainland customer service centres. In 2011, the service scope of the call centre was enhanced. A new hotline was set up specifically for providing enquiry services to Mainland customers.

The Group further invested in the automated banking channels. It upgraded the cheque deposit machines to accept RMB and USD cheques in addition to HKD cheques. This is the first of its kind in Hong Kong. It enhanced the functions of its e-Banking platform, including the extension of FX and Bullion Margin trading hours and functions. In response to customers' increasing usage of mobile smart phones, the mobile banking service was further enriched and expanded.

The Group introduced the Quality Management System for the operations of the Trade Services Centre, which successfully obtained ISO 9001:2008 certification in 2011. In recognition of its well-received electronic platform and outstanding services, the Group was honoured with the "Best Internet Banking" and "Best Mobile Telephone Banking" awards under the Capital Weekly Service Awards 2011. The Group was also awarded by the Hong Kong Call Centre Association ("HKCCA") in 2011 with "HKCCA Grand Award of the Year" and "Asia Pacific Contact Centre Association Leaders ("APCCAL") Recognition Award in Hong Kong Region" and 16 other awards.

CORPORATE BANKING

Financial Results

Corporate Banking recorded a growth of HK$1,675 million, or 24.1%, in profit before taxation. This was attributable to the increase in net interest income as well as net fee and commission income.

Net interest income rose by 30.5%, driven by an expansion in loans and deposits with improvement in the average pricing of lending and deposit spread. Corporate loans and customer deposits grew by 13.5% and 25.0% respectively year-on-year.

Net fee and commission income increased by 17.4%, led by the growth in loan and bills commissions as well as fee income from currency exchange and payment services. Net trading gain rose by 82.8% mainly as a result of the higher income from foreign exchange services.

Business operation

The Group's Corporate Banking business maintained its growth momentum in 2011. Corporate loans grew satisfactorily with improvement in the pricing of new loans. The customer base was further enlarged. A full spectrum of financial services, including cross-border services, was offered to core corporate clients. The Group continued to provide efficient services to the SME segment. The development of the Group's custody and cash management services also made steady progress during the year.

Corporate lending business – 13.5% growth of corporate loans

Owing to the tightening of credit in the Mainland, the demand for corporate loans remained strong during the year. The Group's corporate loans grew by 13.5% with further improvement in the pricing of new loans. By implementing the "Total Solution" and capitalising on its strong cross-border relationship and servicing programmes, namely, the "Global Relationship Manager Programme" and the "Global Unified Facilities Agreement", the Group strengthened its service capabilities and improved its credit and risk management. During the year, the Group refined its management of clientele in different industries, thus furthering its expertise in industry management and bolstering customer and marketing segmentation. In 2011, the Group remained the top mandated arranger in the Hong Kong-Macau syndicated loan market.

SME business – won "SME's Best Partner Award" for the fourth consecutive year

The Group enhanced its services for SME customers by offering total solutions and participating actively in the government's "SME Financing Guarantee Scheme" as well as introducing the new "Bank Special Loan Guarantee Scheme". Closer collaboration with BOC and NCB (China) enabled the Group to acquire new targeted customers. The Group also set up a flagship commercial centre to further meet the banking needs of corporate and SME customers. In May 2011, BOCHK received for the fourth consecutive year the "SME's Best Partner Award" presented by the Hong Kong Chamber of Small and Medium Business Limited.

Trade finance – launch of innovative products

The Group capitalised its strong cross-border capabilities and the further relaxation of the offshore RMB business to capture more business opportunities. In collaboration with BOC, the Group offered cross-border trade finance products, such as RMB short-term overseas financing, to corporate customers in both Hong Kong and the Mainland. Various innovative trade finance products were launched during the year. In 2011, the Group's balance of trade finance rose by 11.4%.

Custody service – further expansion of client base

The Group successfully expanded the client base of its custody service in 2011. In addition to the services provided to Qualified Domestic Institutional Investors and various types of fund clients, the Group also took initiatives to secure business opportunities from RMB Qualified Foreign Institutional Investors. The custody volume of RMB investment instruments was on the increase. The Group continued to provide escrow services to large corporate entities and strengthen its cooperation with professional intermediaries. At the end of 2011, excluding the RMB fiduciary account for participating banks, total assets under the Group's custody were valued at about HK$400 billion.

Cash management service – launch of RMB-related products and services

The Group continued to strengthen its cash management platform. It not only provided Business Integrated Account to SME customers, but also enhanced its liquidity management services. Its Corporate Internet Banking Platform was reinforced to facilitate corporate customers in conducting their local and cross-border business activities. Meanwhile, new products and services were introduced, including a wide range of RMB payment and receivable products. The Group played an important role as the RMB agent bank of the Hong Kong Stock Exchange to facilitate the first RMB share listed in Hong Kong. The remittance points of BOC Remittance Plus increased to about 5,000. During the year, the number of Corporate Banking Services Online ("CBS Online") customers recorded a satisfactory increase.

Risk management – proactive measures in place

To safeguard asset quality, the Group continued to carry out rigorous risk management and credit control. Corporate customers who could be adversely affected by the volatile global economic environment were closely monitored. Market and industry trends were frequently and thoroughly analysed to formulate timely and effective precautionary courses of action. Measures were taken to check customers' fund flow and enhance credit review. The Group was also alert to any new development of the Mainland economy and the potential impact of the Central Government's austerity measures, in particular the latest situation of local government debts. Precautionary measures and prudent credit standards have been put in place for lending to customers and counterparties in vulnerable segments.

MAINLAND BUSINESS

Distribution channels – two new sub-branches and enhanced linkage of service platform with BOC

The Group further strengthened its customer service capability and expanded its network in the Mainland. The linkage of the Group's service platform with those of BOC has been augmented to enable debit card holders of NCB (China) to access services through BOC's network. The Group also upgraded the platform and functionality of its e-banking to enhance customer experience. Close collaboration was fostered with BOC by developing different liaison models to deepen cooperation and explore business referral opportunities. New business platforms have been set up to cater for the expansion of the SME and credit card businesses. During the year, two sub-branches in Zhongguancun, Beijing and the Qingdao Economic & Technical Development Zone respectively commenced operation. NCB (China) also obtained approval to establish its Foshan Sub-branch, Dongguan Sub-branch, Shanghai Huangpu Sub-branch and Chengdu Chuangye Road Sub-branch. By the end of 2011, the Group's total number of branches and sub-branches in the Mainland increased to 27.

Financial performance – customer deposits growing by 52.7%

The Group's Mainland business experienced healthy growth in 2011. It succeeded in further strengthening its deposit base by growing its customer deposits by 52.7%. Advances to customers fell by 8.9% but the overall loan quality remained sound. Operating as a locally incorporated bank, NCB (China)'s loan-to-deposit ratio at the end of 2011 was 70.2%, which was in line with the regulatory requirement. To alleviate the impact of the continued rise in the reserve requirement ratio on the net interest margin, the Group managed to improve its asset mix and loan pricing. Total operating income increased by 42.2% with notable growth in both net interest income and net fee and commission income.

TREASURY

Financial Results

Treasury recorded a strong increase of 19.3% in profit before taxation over the previous year.

Net interest income was up 27.7% with the improvement in the interest spread of RMB funds and the improved yield on debt securities.

Net trading gain improved as net trading gain from foreign exchange activities and bullion transactions increased. However, there was a mark-to-market loss on certain interest rate instruments versus a gain recorded last year.

Business Operation

Proactive investment strategy – reduced exposure to European countries and lower-yielding securities

The Group continued with a proactive approach in managing its banking book investments. The portfolio was well diversified in terms of geographic and counterparty exposure. During the year, the Group extended the portfolio duration and focused more on government-related securities as well as high-quality financial institutions and corporate bonds. In view of rising market volatilities, the Group swiftly adjusted its strategy by improving its portfolio mix to reduce its exposure to European countries and lower-yielding securities. At the end of 2011, the Group had no exposure to debt securities issued by the GIIPS (Greece, Italy, Ireland, Portugal and Spain) financial institutions, governments or other private entities.

RMB-related businesses – major market maker in RMB FX and derivative products in Hong Kong

During the year, the Group acted as the major market maker in the CNH market of Hong Kong and was the first offshore institution with the "Delivery Versus Payment" settlement arrangement in the onshore market. The Group was an active participant in the RMB bond underwriting business. It cooperated with BOC's overseas branches in developing a global RMB banknote network, providing product support and pricing-quoting services to these branches and extending business relationships with central banks and financial institutions in their host countries.

RMB-clearing bank business – providing better clearing bank services for Hong Kong and offshore markets

BOCHK was reappointed as the clearing bank for the offshore RMB business in Hong Kong and as the sole bank to provide RMB banknotes clearing service to Taiwanese banks. The Group further enhanced its clearing services to expand the global RMB business network. It launched the RMB Fiduciary Account Scheme Service to reduce the counterparty risk of the participating banks to the clearing bank. The Group further improved its RMB clearing function and infrastructure. RMB Repo facilities were offered to the participating banks to facilitate intraday liquidity management. The Group also demonstrated its commitment to the promotion of the CNH interbank market and the setting of CNY HIBOR.

INSURANCE

Financial Results

The Group's Insurance segment registered a decline of 93.5% in its profit before taxation to HK$33 million in 2011. The decline was mainly attributable to a higher provision for insurance liabilities as a result of declining market interest rates. The decrease was also caused by the investment loss of its securities portfolio under a highly volatile investment environment.

Net interest income grew by 13.8%, which was mainly driven by the expansion of securities assets acquired with the new premiums received. Gross insurance premiums increased by 49.5% with the sharp rise in regular premiums. During the year, a net charge of impairment allowances on securities investment of HK$167 million was made for BOC Life's debt securities investments mainly in Italy and Ireland which had been disposed of by the end of 2011.

Business Operation

Improved product mix – significant growth of regular premium income

The Group continued to build up its insurance business by implementing a "Needs-based Selling" approach and expanding the product mix. Regular-premium products remained the Group's focus. Total gross regular premium income rose by 56.4% year-on-year. New products, such as the "Tactics Investment Insurance Plan" and "RMB Universal Life Insurance Plan", were launched during the year. In 2011, BOC Life maintained its leading market position in the life insurance business in Hong Kong.

During the year, BOC Life was entered as one of the three finalists for the title of "Life insurance Company of the Year" under the Asia Insurance Industry Awards. In recognition of its outstanding service quality, it was given three awards under the Hong Kong Management Association's Quality Award scheme, namely, the Award for Excellence in Training and Development – Gold Prize, Most Innovative Award and Best Presentation Award.

RMB insurance products – a prominent provider

The Group's leading role in the RMB insurance market was solidified through the development and innovation of RMB insurance products. Popular RMB insurance products such as the "Target 5 Years Insurance Plan Series" and "Multi-Plus Savings Insurance Plan" continued to attract substantial new business. During the year, the new "RMB Universal Life Insurance Plan" was launched to provide customers with lifelong protection and flexibility in target saving.

REGULATORY DEVELOPMENT

Implementation of Basel III

In December 2010, Basel Committee on Banking Supervision ("BCBS") issued *A Global Regulatory Framework for More Resilient Banks and Banking Systems and International Framework for Liquidity Risk Measurement, Standards and Monitoring*. It sets out a better-quality capital framework, the introduction of leverage ratio as a backstop to the risk-based capital requirement, measures to strengthen the resilience of the banking sector against cyclical economic shocks, and the introduction of global liquidity standards. The Group set up a task force led by the senior management to coordinate various units within the Group to comply with the new requirements and monitor the implementation of the Basel III Accord, taking into consideration the Group's development strategy. The Group has conducted a detailed impact analysis on the new capital rules and been in constant dialogue with the regulatory authority. The objective of Basel III is to improve the banking sector's ability to absorb shocks arising from financial and economic stress in the future. The Group will follow HKMA's timetable in the implementation of Basel III.

CREDIT RATINGS

As at 31 December 2011	Long-term	Short-term
Standard & Poor's	A+	A-1
Moody's	Aa3	P-1
Fitch	A	F1

On 29 November 2011, Standard & Poor's raised BOCHK's long-term counterparty credit rating from 'A-' to 'A+' and the short-term counterparty credit rating from 'A-2' to 'A-1'. This rating upgrade demonstrates the effectiveness of the Group's balanced and sustainable development strategy in the past years.

As at 31 December 2011, BOCHK's long-term and short-term local and foreign currency bank deposit ratings assigned by Moody's were 'Aa3' and 'P-1' respectively. The Bank Financial Strength Rating was 'C+'.

In respect of the ratings assigned by Fitch Ratings, BOCHK's long-term and short-term foreign currency issuer default ratings were 'A' and 'F1' respectively while the support rating was '1'.

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 risks 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. The Group has a defined risk appetite statement approved by the Board of Directors ("the Board"), which is an expression of the types and level of risk that the Group is willing to take in order to achieve its business goals and to meet the expectations of its stakeholders under a controllable risk level. For details of the Group's risk management governance structure, please refer to Note 4 to the Financial Statements in this Annual Report.

Credit Risk Management

Credit risk is the risk of loss that a customer or counterparty will be unable to or unwilling to meet its contractual obligations. Credit risk exists in the trading book and banking book, on- and off-balance sheet exposures of a bank. It arises principally from the lending, trade finance and treasury businesses, and covers inter-bank transactions, foreign exchange and derivative transactions as well as investments in bonds and securities. For details of the Group's Credit Risk Management, please refer to Note 4.1 to the Financial Statements in this Annual Report.

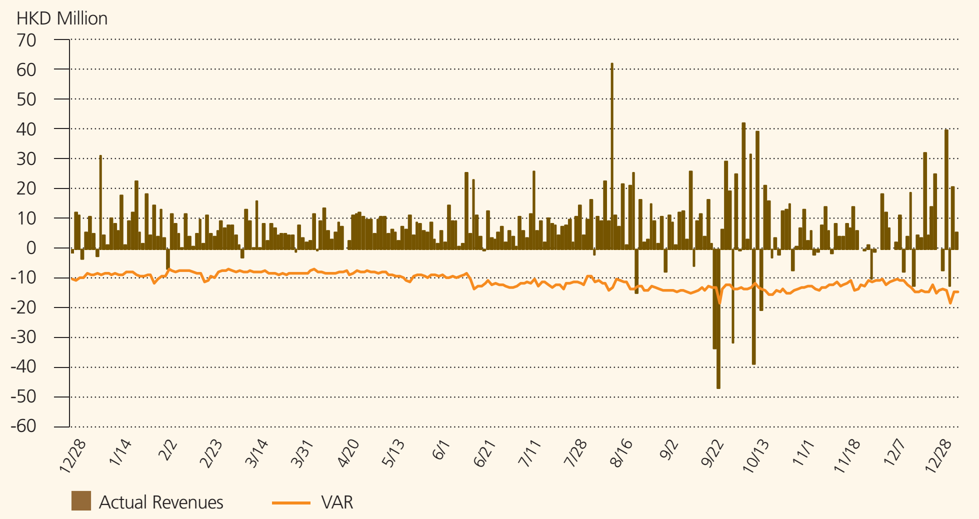
Market Risk Management

Market risk refers to the risk of losses arising from adverse movements in the value of foreign exchange and commodity positions and the trading book interest rate and equity positions held by the Group due to the volatility of financial market price (debt security price/interest rate, foreign exchange rate, equity price, commodity price). The Group adopts robust market risk appetite to achieve balance between risk and return. For details of the Group's market risk management, please refer to Note 4.2 to the Financial Statements in this Annual Report.

The Group uses the VAR technique to measure potential losses and market risks of its trading book for reporting to the Risk Committee ("RC") and senior management on a periodic basis. The Group adopts a uniformed VAR calculation model, using historical simulation approach and 2-year historical data, to calculate VAR of the Group and subsidiaries over 1-day holding period with 99% confidence level, and set up VAR limit of the Group and subsidiaries.

The predictive power of the VAR measure is monitored by back-testing, which compares the calculated VAR figure of trading positions of each business day with the actual revenues arising on those positions on the next business day. Generally speaking, the number of back-testing exceptions in a rolling 12-month period will not exceed four times, given a 99% confidence level. BOCHK conducts back-testing on a monthly basis and the graph below shows the back-testing result of the trading book VAR of BOCHK.

Daily Backtesting in 2011



There were 7 actual losses exceeding the VAR estimates for BOCHK in 2011. The exceptions of the back-testing mainly resulted from unanticipated market movement. In response to this circumstance, measures have been taken by the Group to improve the model.

Interest Rate Risk Management

Interest rate risk means the risks to a bank's earnings and economic value arising from adverse movements in interest rate and term structures of the bank's asset and liability positions. The Group's interest rate risk exposures are mainly structural. The major types of interest rate risk from structural positions are re-pricing risk, basis risk, yield curve risk and options risk. For details of the Group's Interest Rate Risk Management, please refer to Note 4.2 to the Financial Statements in this Annual Report.

Liquidity Risk Management

Liquidity risk is the risk that banks fail to provide sufficient funds to grow assets or pay due obligations, and need to bear an unacceptable loss. The Group adopts a sound liquidity risk appetite to provide stable, reliable and adequate sources of cash to meet liquidity needs under normal circumstances or stressed scenarios; and survive with net positive cumulative cash flow in extreme scenarios, without requesting HKMA to act as the lender of last resort. For details about Liquidity Risk Management, please refer to Note 4.3 to the Financial Statements in this Annual Report.

Operational Risk Management

Operational risk is the risk of loss resulting from an inadequate or failed internal process, any of the staff, the information technology system or an external event. 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 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 policy and procedure on operational risk management are formulated by Operational Risk and Compliance Department ("OR&CD") and approved by the RC.

The Group has adopted the "Three Lines of Defence" model for its operational risk management governance structure: all departments as the first line of defence are the owner of operational risk and are responsible for carrying out the duties and functions of self risk control in the process of business operation through self-assessment, self-checking and self-correction. OR&CD together with certain specialist functional units in relation to operational risk management within the Group are the second line of defence, which is responsible for assessing and monitoring the operational risk condition of the first line of defence, and providing it with guidance. In addition to formulating the operational risk management policy and procedure, OR&CD, being independent from business units, is the central management unit of the Group's operational risk management and also responsible for designing the operational risk assessment methodologies, tools and the reporting mechanism (including the capturing of data on operational risk events loss), monitoring the implementation status of policies and operational procedures in the departments of the first line of defence through operational risk management tools, and assessing and reporting the overall operational risk position to the Management and RC. Certain specialist functional units, including the Human Resources Department, Information Technology Department, Corporate Services Department, OR&CD, Financial Management Department and General Accounting & Accounting Policy Department, are required to carry out their managerial duties of the second line of defence with respect to some specific aspects of operational risk. Besides taking charge of operational risk management in their own units, these units are also required to provide other units with professional advice/training in respect of certain operational risk categories and to lead the corporate-level operational risk management. The Group Audit is the third line of defence which provides independent assessment with respect to the operational risk management framework and is required to conduct periodic audit of the operational risk management activities of various departments/business units within the Group regarding their compliance and effectiveness and to put forward recommendations for corrective actions.

The Group adopts the tools or methodologies such as key risk indicators, self-assessment, operational risk events reporting and review to identify, assess, monitor and control the risks inherent in business activities and products, as well as 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 about 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 other types of risk and 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. Since reputation risk is often caused by various types of operational and strategic issues that negatively impact the trust and perception of the Group, all operational and key risks identified are assessed through the established Key Control Self-Assessment framework, including risk assessment tools, to evaluate the severity of their impact on the Group, including the damage to reputation. In addition, the Group has put in place a framework, including system support, to achieve continuous monitoring of external reputation risk incidents and published failures of risk incidents in the financial industry.

Legal and Compliance Risk Management

Legal risk is the risk that unenforceable contracts, lawsuits or adverse judgments may disrupt or otherwise negatively affect the operations or financial conditions of the Group. Compliance risk is the risk of legal or regulatory sanctions, financial losses or losses in 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 OR&CD, which reports directly to the Chief Risk Officer ("CRO"). All legal matters are handled by the Legal Services Centre ("LSC"), which reports to the Chief Operating Officer. OR&CD is responsible for legal risk management of the Group with support rendered by the LSC. As part of the Group's corporate governance framework, the policy for the management of legal and compliance risk is approved by RC.

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 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 the Group's capital management is to maximise total shareholders' return while maintaining a capital adequacy position in relation to the Group's overall risk profile. The Group periodically reviews its capital structure and adjusts the capital mix where appropriate to achieve the required rate of return on capital.

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 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 response to the core capital requirements under the Basel III Accord, the minimum common equity CAR and minimum core CAR are further introduced in 2011's ICAAP.

Stress Testing

The Group supplements the analysis of various types of risks with stress testing. Stress testing is a risk management tool for estimating risk exposures under stressed conditions arising from extreme but plausible market or macroeconomic movements. These tests are conducted on a regular basis by the Group's various risk management units and ALCO monitors the results against key risk limit approved by the RC. The Financial Management Department reports the combined stress test results to the Board and RC regularly.

BOC Life Insurance

BOC Life's principal business activity 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 and credit risk. BOC Life closely monitors these risks and reports to its RC on a regular basis. The key risks of its insurance business and related risk control process 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. These risks are managed through the application of underwriting policies and reinsurance arrangement.

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

The reinsurance arrangement does not, however, discharge BOC Life's liability as the primary insurer. If a reinsurer fails to pay a claim for any reasons, BOC Life remains liable for the payment to the policyholder. The creditworthiness of reinsurers is considered by reviewing the reinsurers' financial strength prior to finalisation of any contract. BOC life directs its reinsurance placement policy and assesses the creditworthiness of all reinsurers and intermediaries by reviewing credit grades provided by rating agencies and other publicly available financial information. BOC Life also monitors the recoverability of its reinsurance assets on an ongoing basis. It maintains records of the payment history for significant contract holders with whom it conducts regular business.

For details of the Group's Insurance Risk Management, please refer to Note 4.4 to the Financial Statements in this Annual Report.

Interest Rate Risk Management

An increase in interest rates may result in the depreciation of the value of BOC Life's bond portfolio. It may also result in customers accelerating surrenders. A decrease in interest rates may result in an increase in insurance liability and 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 (ALM) 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 they have 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 its credit risk management, BOC Life has strengthened its communication with the Investment Management of the Group while closely monitoring and updating the established Bonds Issuers Disposal and Watch Lists to ensure consistency with the Group's credit risk management and investment strategy.