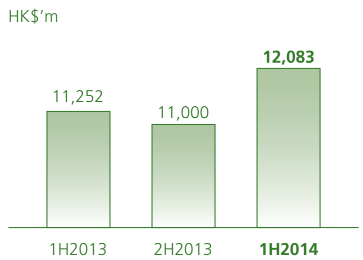
MANAGEMENT'S DISCUSSION AND ANALYSIS

FINANCIAL PERFORMANCE AND CONDITION AT A GLANCE

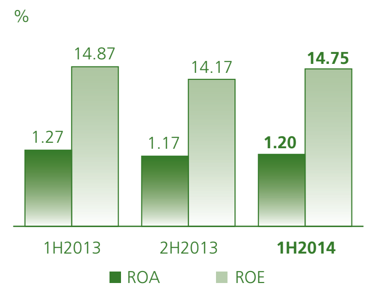
The following table is a summary of the Group's key financial results for the first half of 2014 in comparison with the previous two half-yearly periods.

Key Performance Trends

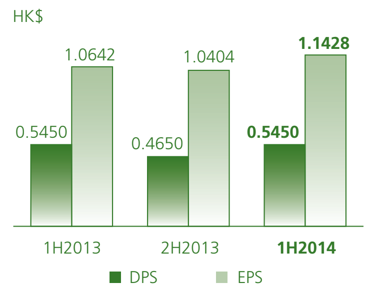
Profit Attributable to the Equity Holders



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

- Profit attributable to the equity holders increased by 7.4% year-on-year to HK$12,083 million. Operating profit after impairment allowances rose by 9.7%, driven by the growth of core income.

Solid return with sustainable growth in core income

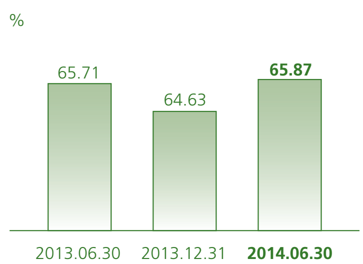
- ROE was 14.75%, down 0.12 percentage point year-on-year, as the increase in average equity outpaced that of the profit. Higher average equity was mainly caused by increment in average retained earnings and premises revaluation reserve.
- ROA was 1.20%.

Return to shareholders

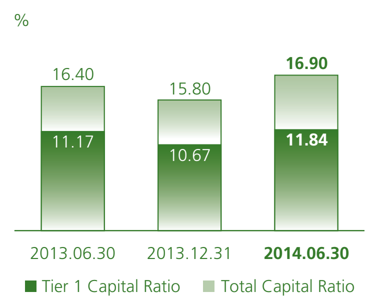
- EPS was HK$1.1428. Interim dividend per share was HK$0.545.

Financial Position

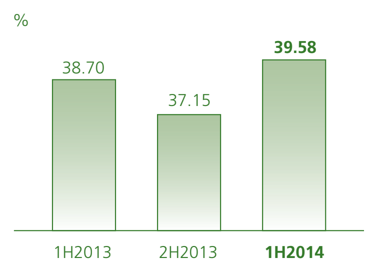
Loan to Deposit Ratio[3]



Capital Ratio[4]



Average Liquidity Ratio[5]



Balanced growth in loans and deposits

- Advances to customers increased by 10.5% while deposits from customers grew by 8.5% from the end of 2013. Loan to deposit ratio was 65.87%.

Enhanced capital position to support business growth

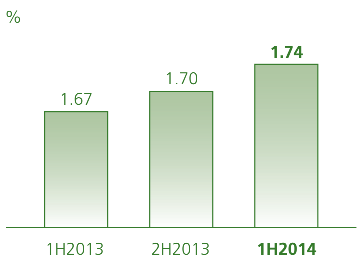
- The Group adopted proactive capital management to meet more stringent regulatory requirements and capture long-term business opportunities. Total capital ratio was 16.90% while Tier 1 capital ratio improved to 11.84%.

Sound liquidity position

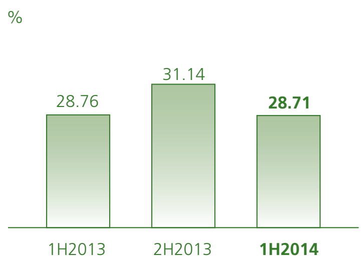
- Average liquidity ratio stood at a sound level at 39.58%.

Key Operating Ratios

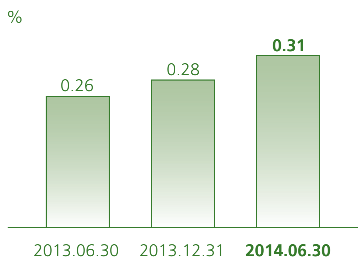
Net Interest Margin ("NIM")



Cost to Income Ratio



Classified or Impaired Loan Ratio[6]



Improvement in NIM with optimised asset mix

- NIM was 1.74%, up 7 basis points year-on-year and 4 basis points half-on-half. The increase was mainly attributable to the growth in higher-yielding assets, partly offset by the narrowing of loan and deposit spread.

Cautious cost control

- Cost to income ratio was 28.71%, down 0.05 percentage point year-on-year, among the lowest in the industry.

Classified or impaired loan ratio stayed at a low level

- Classified or impaired loan ratio remained low at 0.31%, below the market average.

1. Return on Average Shareholders' Equity as defined in "Financial Highlights".
2. Return on Average Total Assets as defined in "Financial Highlights".
3. The deposit base also includes structured deposits reported as "Financial liabilities at fair value through profit or loss".
4. The capital ratios are 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 Banking (Capital) (Amendment) Rules 2012 and the Banking (Capital) (Amendment) Rules 2013 came into operation on 1 January 2013 and 30 June 2013 respectively. The bases of regulatory capital calculation for credit risk, market risk and operational risk are described in Note 3.5 to the Interim Financial Information.
5. The average liquidity ratio is calculated as the simple average of each calendar month's average liquidity ratio of BOCHK for the period.
6. Classified or impaired loans 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

In the first half of 2014, recovery in major economies remained broadly on track although growth momentum was modest. While the US economic recovery stayed intact, further monetary easing by other major central banks, notably the European Central Bank, suggested that the path of recovery in other advanced economies remained challenging. In the Mainland of China, economic expansion slowed down in the first quarter of 2014 before gradually moving upwards in the second quarter. The headwinds in the property market posed downside risk to economic development. Nevertheless, targeted measures introduced by the Central Government have helped stabilise the growth momentum.

Domestic demand continued to provide support to the Hong Kong economy but GDP growth receded in the first quarter of the year due to weak external demand and eased private consumption. The local residential property market remained static in the first half of the year although transaction volumes picked up gradually in the second quarter. Meanwhile, volatility of the local stock market increased resulting from concerns over the prospects of the Mainland economy and the normalisation of US monetary policy.

Overall liquidity in the banking sector stayed abundant and market interest rates remained low. Average 1-month HIBOR and USD LIBOR fell from 0.22% and 0.20% in June 2013 to 0.21% and 0.15% respectively in June 2014. Meanwhile, long-term interest rates rose. The average 10-year HKD Swap rate and USD Swap rate rose from 2.29% and 2.49% in June 2013 to 2.58% and 2.69% respectively in June 2014.

In the first half of 2014, the offshore RMB business continued to grow steadily. The turnover of Hong Kong's RMB Real Time Gross Settlement system substantially increased as compared to same period of last year, reflecting considerable growth in the use of RMB in trade, investment and financing activities. A number of initiatives were introduced to promote the use of RMB globally. These included widening the range of RMB daily price volatility, the announcement of the launch of a direct share-dealing scheme between Hong Kong and Shanghai, namely the "Shanghai-Hong Kong Stock Connect", the release of detailed rules for the free trade account system in the China (Shanghai) Pilot Free Trade Zone ("Shanghai Free Trade Zone") and the signing of Memorandum of Understanding by the People's Bank of China with other central banks regarding the establishment of the clearing and settlement arrangement of RMB payments in different countries. These initiatives boosted the development of the cross-border and offshore RMB businesses.

The banking industry in Hong Kong continued to operate in a mixed environment in the first half of 2014. Weak external demand and keen market competition restricted banks' growth and profitability. The upward trend in non-performing loans on the Mainland also placed pressure on banks' Mainland exposures. Nevertheless, the introduction of new financial policies by the Mainland would provide opportunities to banks for expanding their business and capturing new customers.

CONSOLIDATED FINANCIAL REVIEW

Financial Highlights

HK$'m	**Half-year ended 30 June 2014**	Half-year ended 31 December 2013	Half-year ended 30 June 2013
Net operating income before impairment allowances	**21,649**	20,522	19,791
Operating expenses	**(6,216)**	(6,391)	(5,692)
Operating profit before impairment allowances	**15,433**	14,131	14,099
Operating profit after impairment allowances	**15,054**	13,765	13,728
Profit before taxation	**15,179**	13,845	13,948
Profit attributable to the equity holders of the Company	**12,083**	11,000	11,252

In the first half of 2014, the Group built on its diversified platforms and fully capitalised on its strong franchise to solidify its market leadership. It continued to work more closely with BOC to capture business opportunities and maintained disciplined cost control. At the same time, it maintained prudent risk management principles to safeguard its asset quality. As a result, the Group achieved encouraging financial results in the first half of 2014 with key financial ratios staying at healthy levels.

The Group's net operating income before impairment allowances rose by HK$1,858 million or 9.4% year-on-year to HK$21,649 million in the first half of 2014. The increase was driven by the strong growth in net interest income, which was attributable to the growth in customer loan and deposit balances as well as an increase in higher-yielding RMB assets. Net fee and commission income also rose. The increases were partially offset by the lower mark-to-market gain from certain treasury products and the decline in income from the Group's insurance segment. Operating expenses rose, as the Group continued to invest to support its long-term growth. Net charge of impairment allowances increased moderately. Operating profit after impairment allowances increased by HK$1,326 million, or 9.7%. Meanwhile, the net gain from fair value adjustments on investment properties declined on a year-on-year basis. Profit attributable to the equity holders rose by HK$831 million, or 7.4%.

As compared to the second half of 2013, the Group's net operating income before impairment allowances increased by HK$1,127 million, or 5.5%. The growth in income was mainly driven by the increase in net interest income and net fee and commission income. The increases were partly offset by the lower mark-to-market gain from the banking business and the decline in income from the Group's insurance segment. Operating expenses fell while net gain from fair value adjustments on investment properties rose. Profit attributable to the equity holders increased by HK$1,083 million, or 9.8%, on a half-on-half basis.

INCOME STATEMENT ANALYSIS

Net Interest Income and Margin

HK$'m, except percentages	**Half-year ended 30 June 2014**	Half-year ended 31 December 2013	Half-year ended 30 June 2013
Interest income	**23,304**	20,920	18,459
Interest expense	**(7,648)**	(6,335)	(5,128)
Net interest income	**15,656**	14,585	13,331
Average interest-earning assets	**1,814,625**	1,706,560	1,607,052
Net interest spread	**1.62%**	1.59%	1.58%
Net interest margin*	**1.74%**	1.70%	1.67%

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

Compared to the first half of 2013, the Group's net interest income increased by HK$2,325 million or 17.4%. The increase was driven by both the growth in average interest-earning assets and the widening of net interest margin.

Average interest-earning assets expanded by HK$207,573 million or 12.9% year-on-year, with growth in loans to customers as well as balances and placements with banks. These were supported by the increases in customer deposits and deposits and balances from banks.

Net interest margin widened by 7 basis points to 1.74%. The increase was mainly attributable to the increase in higher-yielding assets such as loans to customers, RMB bonds as well as balances and placements with banks. Higher RMB market interest rates resulted an increase in the average yield of balances and placements with banks, which also contributed to the widening of net interest margin. The positive impact was partly offset by the narrowing of loan and deposit spread as the average yield of customers' loans lowered while deposit costs rose, both of which were affected by intense market competition.

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

	Half-year ended 30 June 2014		Half-year ended 31 December 2013		Half-year ended 30 June 2013	
ASSETS	**Average balance HK$'m**	**Average yield %**	Average balance HK$'m	Average yield %	Average balance HK$'m	Average yield %
Balances and placements with banks and other financial institutions	**434,892**	**3.11**	368,980	2.80	291,332	2.34
Debt securities investments	**455,880**	**2.49**	486,874	2.24	510,305	2.06
Loans and advances to customers	**907,670**	**2.42**	836,095	2.40	791,467	2.49
Other interest-earning assets	**16,183**	**1.21**	14,611	1.31	13,948	1.66
Total interest-earning assets	**1,814,625**	**2.59**	1,706,560	2.43	1,607,052	2.32
Non interest-earning assets	**246,667**	**–**	237,049	–	229,264	–
Total assets	**2,061,292**	**2.28**	1,943,609	2.14	1,836,316	2.03
LIABILITIES	**Average balance HK$'m**	**Average rate %**	Average balance HK$'m	Average rate %	Average balance HK$'m	Average rate %
Deposits and balances from banks and other financial institutions	**207,172**	**0.85**	191,646	0.80	119,554	0.45
Current, savings and time deposits	**1,306,950**	**0.99**	1,225,221	0.86	1,187,636	0.77
Certificates of deposit issued	**149**	**0.78**	–	–	–	–
Subordinated liabilities	**19,704**	**0.59**	20,188	0.35	28,178	0.59
Other interest-bearing liabilities	**51,086**	**1.05**	50,193	0.97	54,593	0.82
Total interest-bearing liabilities	**1,585,061**	**0.97**	1,487,248	0.84	1,389,961	0.74
Non interest-bearing deposits	**89,080**	**–**	88,169	–	84,812	–
Shareholders' funds* and non interest-bearing liabilities	**387,151**	**–**	368,192	–	361,543	–
Total liabilities	**2,061,292**	**0.75**	1,943,609	0.65	1,836,316	0.56

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

Compared to the second half of 2013, net interest income increased by HK$1,071 million or 7.3%, driven by higher average interest-earning assets and net interest margin. Average interest-earning assets grew by HK$108,065 million or 6.3%, which was supported by the increases in customer deposits as well as deposits and balances from banks. Net interest margin was up 4 basis points. This was mainly attributable to the increase in higher-yielding assets such as loans to customers as well as balances and placements with banks. However, the increase in deposit costs limited the growth of net interest margin.

Net Fee and Commission Income

HK$'m	**Half-year ended 30 June 2014**	Half-year ended 31 December 2013	Half-year ended 30 June 2013
Credit card business	**1,792**	1,782	1,734
Securities brokerage	**1,180**	1,208	1,224
Loan commissions	**1,134**	822	1,078
Insurance	**677**	577	708
Funds distribution	**513**	380	441
Bills commissions	**413**	432	387
Payment services	**300**	343	322
Trust and custody services	**206**	206	181
Safe deposit box	**136**	122	122
Currency exchange	**105**	109	88
Others	**259**	226	224
Fee and commission income	**6,715**	6,207	6,509
Fee and commission expense	**(1,900)**	(1,923)	(1,828)
Net fee and commission income	**4,815**	4,284	4,681

Net fee and commission income grew by HK$134 million, or 2.9%, year-on-year to HK$4,815 million. Commission income from funds distribution increased by 16.3% as the Group rolled out products and themed marketing campaigns to meet targeted customers' needs. Loan commissions rose by 5.2%, due mainly to higher commission income from corporate loans. Commission income from credit cards, bills, trust and custody services as well as currency exchange also recorded healthy growth. Meanwhile, commission income from securities brokerage decreased by 3.6% in a sluggish local stock market. Commission income from insurance and payment services also declined. The increase in fee and commission expense was mainly caused by higher credit cards related expenses.

Compared to the second half of 2013, net fee and commission income grew by HK$531 million or 12.4%. There was an increase in commission income from loans, funds distribution and insurance. Fee and commission income from payment services, securities brokerage and bills declined.

Net Trading Gain/(Loss)

HK$'m	**Half-year ended 30 June 2014**	Half-year ended 31 December 2013	Half-year ended 30 June 2013
Foreign exchange and foreign exchange products	**829**	933	1,019
Interest rate instruments and items under fair value hedge	**493**	376	197
Commodities	**23**	49	42
Equity instruments	**(16)**	158	183
Net trading gain	**1,329**	1,516	1,441

Net trading gain was HK$1,329 million, decreasing by HK$112 million, or 7.8% from the first half of 2013. Net trading gain from foreign exchange and foreign exchange products dropped by HK$190 million, primarily due to the mark-to-market losses on certain foreign exchange products. Net trading gain from interest rate instruments and items under fair value hedge rose by HK$296 million, mainly attributable to the mark-to-market changes of certain debt securities, caused by market interest rate movements. There was a net trading loss from equity instruments as opposed to a net gain in the first half of 2013, mainly due to the mark-to-market changes and lower net gain from certain equity securities.

Compared to the second half of 2013, net trading gain decreased by HK$187 million or 12.3%. The decrease was mainly attributable to the mark-to-market changes of certain foreign exchange products and equity securities, offset by the mark-to-market gain of certain debt securities.

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

HK$'m	**Half-year ended 30 June 2014**	Half-year ended 31 December 2013	Half-year ended 30 June 2013
Net gain/(loss) on financial instruments designated at fair value through profit or loss	**18**	361	(520)

The Group recorded a net gain of HK$18 million on financial instruments designated at FVTPL in the first half of 2014, compared to a net loss of HK$520 million in the first half of 2013. The change was mainly attributable to the mark-to-market changes of debt securities of BOCG Life, caused by market interest rate movements. The changes in market value of its securities portfolio were offset by the corresponding changes in policy reserves, as reflected in the changes in net insurance benefits and claims which were attributable to the movement of market interest rates.

Compared to the second half of 2013, net gain on financial instruments designated at FVTPL was down by HK$343 million or 95.0%. The decline was mainly due to the higher net gain from equity investments of BOCG Life recorded in the second half of 2013.

Operating Expenses

HK$'m	**Half-year ended 30 June 2014**	Half-year ended 31 December 2013	Half-year ended 30 June 2013
Staff costs	**3,489**	3,585	3,234
Premises and equipment expenses (excluding depreciation)	**814**	832	744
Depreciation on owned fixed assets	**900**	853	810
Other operating expenses	**1,013**	1,121	904
Total operating expenses	**6,216**	6,391	5,692

	At 30 June 2014	At 31 December 2013	At 30 June 2013
Staff headcount measured in full-time equivalents	**14,623**	14,647	14,416

Total operating expenses increased by HK$524 million, or 9.2%, to HK$6,216 million year-on-year, reflecting the Group's continuous investment in servicing capabilities and new business platforms. Meanwhile, the Group remained focused on disciplined cost control.

Staff costs increased by 7.9%, mainly due to higher salaries following the annual salary increment and the increase in performance-related remuneration.

Premises and equipment expenses were up 9.4% with higher rental for branches in Hong Kong and the Mainland of China, as well as higher IT costs.

Depreciation on owned fixed assets rose by 11.1%, due to larger depreciation charge on premises following the upward property revaluation in Hong Kong and on IT equipment as the Group continued to invest in its IT infrastructure.

Other operating expenses were up 12.1%, mainly due to higher expenses in connection with the increasing business volume and higher business taxes of NCB (China).

Compared to the second half of 2013, operating expenses declined by HK$175 million, or 2.7%. The decrease was due to lower staff costs, promotion and maintenance expenses in the first half of 2014.

Net Charge of Loan Impairment Allowances

HK$'m	**Half-year ended 30 June 2014**	Half-year ended 31 December 2013	Half-year ended 30 June 2013
Net charge of allowances before recoveries			
– individual assessment	**(152)**	(231)	(82)
– collective assessment	**(326)**	(229)	(476)
Recoveries	**101**	98	190
Net charge of loan impairment allowances	**(377)**	(362)	(368)

The net charge of loan impairment allowances was HK$377 million in the first half of 2014, increasing mildly by HK$9 million or 2.4% year-on-year. Net charge of individually assessed impairment allowances amounted to HK$152 million, mainly caused by the downgrade of a few corporate loans. The lower net charge of collectively assessed impairment allowances was primarily due to the periodic review of the parameter values in the assessment model in the first half of 2014. Meanwhile, recoveries amounted to HK$101 million, down HK$89 million, or 46.8%.

Compared to the second half of 2013, net charge of loan impairment allowances increased by HK$15 million, or 4.1%. The higher net charge of collectively assessed impairment allowances as a result of higher loan growth was partly offset by the lower net charge of individually assessed impairment allowances.

BALANCE SHEET ANALYSIS

Asset Deployment

HK$'m, except percentages	**At 30 June 2014 Amount**	**At 30 June 2014 % of total**	At 31 December 2013 Amount	At 31 December 2013 % of total
Cash and balances with banks and other financial institutions	**340,517**	**16.3**	353,741	17.3
Placements with banks and other financial institutions maturing between one and twelve months	**33,496**	**1.6**	46,694	2.3
Hong Kong SAR Government certificates of indebtedness	**92,680**	**4.4**	99,190	4.8
Securities investments[1]	**466,236**	**22.4**	484,213	23.6
Advances and other accounts	**1,013,705**	**48.6**	924,943	45.2
Fixed assets and investment properties	**67,871**	**3.3**	66,955	3.3
Other assets[2]	**70,731**	**3.4**	71,200	3.5
Total assets	**2,085,236**	**100.0**	2,046,936	100.0

1. Securities investments comprise investment in securities and financial assets at fair value through profit or loss.
2. Interests in associates and a joint venture, deferred tax assets and derivative financial instruments are included in other assets.

MANAGEMENT'S DISCUSSION AND ANALYSIS

As at 30 June 2014, the Group's total assets amounted to HK$2,085,236 million, increasing by HK$38,300 million or 1.9% from the end of 2013. The Group continued to optimise asset allocation to enhance profitability.

Key changes in the Group's total assets include:

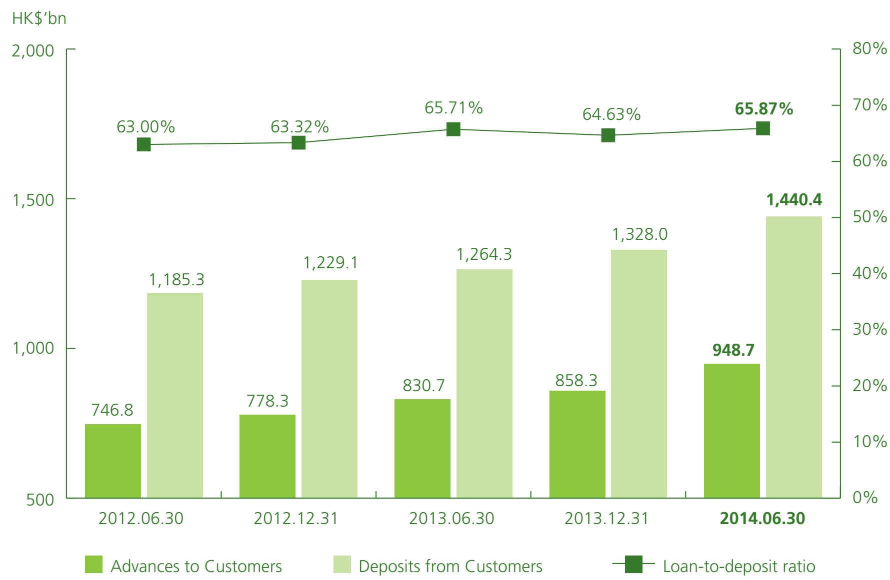
- Cash and balances with banks and other financial institutions decreased by 3.7%, mainly due to the decrease in RMB funds placed with the People's Bank of China by BOCHK's clearing business as participating banks decreased their RMB deposits with the clearing bank.

- Placements with banks and other financial institutions maturing between one and twelve months decreased by 28.3% as the Group redeployed its funds in higher-yielding assets such as advances to customers.

- Securities investments decreased by 3.7% as the Group proactively reduced its exposure to lower-yielding securities to optimise portfolio mix. Meanwhile, it increased its holdings in high-quality corporate bonds and RMB-denominated securities.

- Advances and other accounts rose by 9.6%, mainly attributable to the growth in advances to customers by 10.5%.

Advances to customers and deposits from customers*



* Deposits from customers include structured deposits

Advances to Customers

	At 30 June 2014		At 31 December 2013	
HK$'m, except percentages	**Amount**	**% of total**	Amount	% of total
Loans for use in Hong Kong	**562,418**	**59.3**	507,971	59.2
Industrial, commercial and financial	**310,341**	**32.7**	267,632	31.2
Individuals	**252,077**	**26.6**	240,339	28.0
Trade finance	**92,749**	**9.8**	85,413	9.9
Loans for use outside Hong Kong	**293,537**	**30.9**	264,948	30.9
Total advances to customers	**948,704**	**100.0**	858,332	100.0

The Group's proactive strategies to pursue quality growth over the years have put it in a strong position to benefit from business opportunities. Notwithstanding this, it continued to adopt stringent lending policy and focus on customer selection to achieve sustainable loan growth. Advances to customers grew by HK$90,372 million or 10.5% to HK$948,704 million in the first half of 2014.

Loans for use in Hong Kong grew by HK$54,447 million or 10.7%.

- Lending to the industrial, commercial and financial sectors increased by HK$42,709 million, or 16.0%. Loans to the manufacturing, wholesale and retail trade, transport and transport equipment as well as information technology grew by 28.6%, 13.4%, 11.1% and 30.9% respectively.

- Lending to individuals increased by HK$11,738 million, or 4.9%. Residential mortgage loans (excluding those under the Government-sponsored home purchasing schemes) grew by 2.0%.

Trade finance increased by HK$7,336 million, or 8.6%. Meanwhile, loans for use outside Hong Kong grew by HK$28,589 million, or 10.8%.

Loan Quality

HK$'m, except percentage amounts	**At 30 June 2014**	At 31 December 2013
Advances to customers	**948,704**	858,332
Classified or impaired loan ratio	**0.31%**	0.28%
Impairment allowances	**4,494**	4,235
Regulatory reserve for general banking risks	**9,801**	8,994
Total allowances and regulatory reserve	**14,295**	13,229
Total allowances as a percentage of advances to customers	**0.47%**	0.49%
Impairment allowances[1] on classified or impaired loan ratio	**34.03%**	36.09%
Residential mortgage loans[2] – delinquency and rescheduled loan ratio[3]	**0.02%**	0.02%
Card advances – delinquency ratio[3]	**0.23%**	0.18%

	Half-year ended 30 June 2014	Half-year ended 30 June 2013
Card advances – charge-off ratio[4]	**1.45%**	1.43%

1. 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.
2. Residential mortgage loans exclude those under the Home Ownership Scheme and other government-sponsored home purchasing schemes.
3. Delinquency ratio is measured by a ratio of total amount of overdue loans (more than three months) to total outstanding loans.
4. 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 remained solid. The classified or impaired loan ratio was at 0.31%. Classified or impaired loans rose by HK$497 million, or 20.4%, to HK$2,930 million, due to the downgrade of a few corporate loans. Formation of new classified or impaired loans in the first half of 2014 represented approximately 0.23% of total loans outstanding.

Total impairment allowances, including both individual assessment and collective assessment, amounted to HK$4,494 million. Total impairment allowances on classified or impaired loans as a percentage of total classified or impaired loans was at 34.03%.

The credit quality of the Group's residential mortgage loans and credit cards remained sound. The combined delinquency and rescheduled loan ratio of residential mortgage loans stood at 0.02% at the end of June 2014. The charge-off ratio of card advances remained low at 1.45% in the first half of 2014, amid an upward trend in the market.

*Deposits from Customers**

HK$'m, except percentages	At 30 June 2014 Amount	% of total	At 31 December 2013 Amount	% of total
Demand deposits and current accounts	**103,033**	**7.2**	104,784	7.9
Savings deposits	**621,513**	**43.1**	636,137	47.9
Time, call and notice deposits	**711,816**	**49.4**	583,227	43.9
	1,436,362	**99.7**	1,324,148	99.7
Structured deposits	**4,014**	**0.3**	3,832	0.3
Deposits from customers	**1,440,376**	**100.0**	1,327,980	100.0

* Including structured deposits

The Group maintained a flexible deposit strategy to support business growth. Its deposit base was up HK$112,396 million, or 8.5%, to HK$1,440,376 million in the first half of 2014, driven by the increase of 22.0% in time, call and notice deposits in response to market changes. Demand deposits and current accounts decreased by 1.7% while savings deposits fell by 2.3%. The Group's loan to deposit ratio was 65.87% at the end of June 2014, up 1.24 percentage points from the end of 2013.

Capital and Reserves Attributable to the Equity Holders of the Company

HK$'m	At 30 June 2014	At 31 December 2013
Share capital	**52,864**	52,864
Premises revaluation reserve	**35,944**	34,682
Reserve for fair value changes of available-for-sale securities	**2,360**	488
Regulatory reserve	**9,801**	8,994
Translation reserve	**803**	1,051
Retained earnings	**67,093**	60,734
Reserves	**116,001**	105,949
Capital and reserves attributable to the equity holders of the Company	**168,865**	158,813

Capital and reserves attributable to the equity holders increased by HK$10,052 million, or 6.3% to HK$168,865 million at 30 June 2014. Retained earnings rose by 10.5%, reflecting the profit for the first half of 2014 after the appropriation of final dividend of 2013. Premises revaluation reserve increased by 3.6%, which was attributable to the increase in property prices in the first half of 2014. Regulatory reserve rose by 9.0%, mainly due to loan growth. Reserve for fair value changes of available-for-sale securities increased strongly, due to lowering market interest rates.

Capital and Liquidity Ratio

HK$'m, except percentages	**At 30 June 2014**	At 31 December 2013
Consolidated capital after deductions		
Common Equity Tier 1 capital	**104,971**	92,112
Additional Tier 1 capital	**733**	894
Tier 1 capital	**105,704**	93,006
Tier 2 capital	**45,216**	44,683
Total capital	**150,920**	137,689
Total risk-weighted assets	**892,942**	871,618
Common Equity Tier 1 capital ratio	**11.76%**	10.57%
Tier 1 capital ratio	**11.84%**	10.67%
Total capital ratio	**16.90%**	15.80%

	Half-year ended 30 June 2014	Half-year ended 30 June 2013
Average liquidity ratio	**39.58%**	38.70%

The capital ratios are computed on a 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.

In view of the capital needs for meeting more stringent regulatory requirements and capturing business opportunities in the future, the Group adopted proactive measures to manage its capital for sustainable growth. From 2013, the Group adjusted its target dividend payout range to strengthen its capital base through internal retention. At the same time, the Group continued to optimise the risk-weights of its assets.

Total capital ratio at 30 June 2014 was 16.90%, up 1.10 percentage points from that at the end of 2013. Total capital expanded by 9.6% to HK$150,920 million, mainly due to the increase in retained earnings and reserve for fair value changes of available-for-sale securities. Total risk-weighted assets edged up by 2.4%, mainly from changes in credit risk-weighted assets in the first half of 2014.

The average liquidity ratio in the first half of 2014 stayed sound at 39.58%.

BUSINESS REVIEW

Business Segment Performance

Profit/(Loss) before Taxation by Business Segments

	Half-year ended 30 June 2014		Half-year ended 30 June 2013	
HK$'m, except percentages	Amount	% of total	Amount	% of total
Personal Banking	3,388	22.3	3,572	25.6
Corporate Banking	6,379	42.0	5,873	42.1
Treasury	5,367	35.4	3,918	28.1
Insurance	278	1.8	564	4.0
Others	(233)	(1.5)	21	0.2
Total profit before taxation	15,179	100.0	13,948	100.0

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

PERSONAL BANKING

Financial Results

Personal Banking recorded a decrease of HK$184 million, or 5.2%, in profit before taxation. Net interest income and net fee and commission income increased. The increase was, however, offset by the lower net trading gain and the higher operating expenses.

Net interest income increased by 5.1%. This was mainly driven by the increase in average balance of loans and deposits coupled with the improvement in deposit spread. The growth was partly offset by the decrease in loan spread. Personal loans and deposits grew by 5.8% and 4.9% respectively from the end of 2013.

Net fee and commission income increased by 1.6%. The growth was attributable to the higher income from funds distribution, insurance and credit cards. However, the growth was partially offset by the decrease in income from securities brokerage and payment services.

Net trading gain decreased by 36.0%, caused by the mark-to-market changes of equity securities and the lower net gain from foreign exchange related products.

Operating expenses were up 6.5%, mainly due to increase in staff costs and rental expenses for branches.

Business operation

The Group's Personal Banking business saw steady growth in the first half of 2014. It maintained its leading position in new mortgage loans and continued to optimise the securities brokerage business amid a challenging investment environment. The credit card business enhanced its service offerings and strengthened its market leadership in UnionPay card business. The Group's enhanced customer segmentation strategy, especially the launch of Enrich Banking, enabled it to better cater for the diverse needs of customers and to attract new customers, resulting in the building of stronger customer relationships. The Group also tailored targeted sales and promotions to different customer segments and developed an edge in cross-border services, resulting in a satisfactory expansion of client base in both wealth management and private banking.

Residential mortgages – reinforcing market leadership

Residential property market activity remained low in the first quarter of the year and gradually picked up in the second quarter. During the period, the Group launched the Mortgage Expert mobile application, a one-stop mortgage service which provides customers with the convenience of property valuation upper and lower price alert function, the first time this has been available in the market, and other features including mortgage budget planner and online appointment booking for mortgage applications. The Group also worked in close partnership with major property developers and participated in joint promotions of primary property development projects. The Group continued its mortgage top-up and re-financing promotion efforts to provide an extensive range of products and services across all channels. As a result, the Group maintained its leadership position in new mortgage loans.

Investment and insurance businesses – continuous growth in funds distribution business

The local stock market lost direction in the first half of 2014 as market sentiment turned gloomy due to uncertainty about economic growth on the Mainland. Nevertheless, the Group made continuous efforts to increase securities brokerage business volume. The Group's Monthly Stocks Savings Plan was enhanced with more diversified choices of stocks and the introduction of RMB-denominated stocks to further enhance the Group's competitive edge in RMB services. The Securities Club offered high-net-worth customers with differentiated services to foster customer loyalty. Riding on the opportunities arising from the expected commencement of Shanghai-Hong Kong Stock Connect in the second half of the year, the Group has set up a task force for the formal launch of A-share trading service. Meanwhile, various promotional campaigns were launched to acquire new customers and encourage securities transactions.

In the funds distribution business, the Group continued to broaden its product offerings. A number of currency-hedged funds including RMB and AUD were introduced to meet customers' investment needs. The Group continued to deepen relationships with existing customers and actively pursued new customers. It conducted themed marketing campaigns and investment seminars to help customers further diversify their investment portfolios.

With regards to the Bancassurance business, the Group maintained its leading position in the Hong Kong RMB insurance market by offering a diversified range of products. It also ran a series of marketing campaigns to reinforce the Group's brand image.

Credit card business – recognised leader in UnionPay card business

The Group's credit card business sustained its growth momentum in the first half of 2014. It maintained its leadership in the UnionPay merchant acquiring business and card issuing business in Hong Kong. The BOCHK e-Wallet – Mobile Payment Services introduced in 2013 were further extended to support UnionPay QuickPass payment. This was the first such service in the market, allowing customers to enjoy cross-border dual-currency mobile payment. The Group also launched the first 3-in-1 Contactless Payment Service in the market, allowing merchants to accept Visa payWave, MasterCard PayPass as well as UnionPay QuickPass with one reader.

Wealth management service – satisfactory growth of customer base

The Group aims to provide personalised services and professional financial solutions to meet customers' wealth management needs. It rolled out a series of marketing programmes to enhance brand image and increase penetration with targeted customers. The implementation of a customer re-segmentation strategy enabled the Group to explore and expand business opportunities based on the needs and growth potential of various customer groups. Both the Wealth Management and the newly introduced Enrich Banking brands contributed to satisfactory growth in terms of number of customers and the related Total Relationship Balance.

The Group's Private Banking business continued to make good progress. It continued to develop designated private banking products and services, optimise the business platform and raise brand awareness. The Group captured market opportunities and introduced RMB-related products, which were well received by clients. Exclusive investment seminars, charitable activities and exhibitions helped to foster client relationships. Furthermore, the Group stepped up its collaboration with BOC to reach out to high-net-worth customers with cross-border wealth management needs. As a result, it achieved encouraging growth in both the number of Private Banking clients and their assets under management.

Distribution channels – strengthening automated banking channels

The Group continued to optimise its distribution channels to meet the needs of customers. At the end of June 2014, the Group's service network in Hong Kong comprised 262 branches, including 133 wealth management centres. Automated banking channels were expanded in terms of coverage points and facilities. Call center services were enhanced with the 24-hour Online Chat service being extended to Wealth Management customers.

CORPORATE BANKING

Financial Results

Corporate Banking recorded a growth of HK$506 million, or 8.6%, in profit before taxation. This was mainly attributable to the increase in net interest income as well as net fee and commission income.

Net interest income rose by 6.0%, mainly driven by the increase in average balance of loans and deposits together with the improvement in deposit spread. The growth was largely offset by the decrease in loan spread. Corporate loans and deposits grew by 12.5% and 12.1% respectively compared with the end of 2013.

Net fee and commission income increased by 7.1%, largely led by the growth in commission income from loans, bills and trust services.

Business operation

The Group's Corporate Banking business continued to make important headway in the first half of 2014. Working more closely with BOC in various business areas, the Group successfully expanded its customer base and captured new business opportunities with leading enterprises, financial institutions and banks from the Mainland and overseas. It arranged cross-border direct loans for Mainland corporates to support their overseas expansions. In the custody business, the Group continued to expand its business coverage over different geographical locations. It further leveraged its competitive advantages and strengthened its service capabilities in the cash management business.

Corporate lending business – a prominent loan arranger in Hong Kong

The Group expanded its customer base and enhanced its position as a prominent loan arranger in Hong Kong. The two-way information exchange and business referral channel established with BOC continued to serve its major purpose. The Group also set up a regional co-operation mechanism with BOC Group's offices in Guangdong, Hong Kong and Macau, further raising the BOC Group's service capabilities for customers in these three regions. Through collaboration with BOC, the Group captured new business opportunities with leading enterprises in certain major industries on the Mainland and overseas. It actively participated in a number of significant syndicated loans. The Group also arranged cross-border direct loans for Mainland corporates to support their overseas expansions. Riding on its strong franchise in RMB business, the Group secured relationships with financial institutions and central banks from different overseas regions. Meanwhile, the Group successfully conducted the Shanghai Free Trade Zone Seminar which received overwhelming response. Capitalising on business opportunities from the Shanghai Free Trade Zone, the Group successfully helped corporates set up cross-border funding pools in RMB and other foreign currencies and underwrote cross-border RMB loans to corporates established in the Shanghai Free Trade Zone. At the end of June 2014, the Group's balance of corporate loans grew by 12.5% from the end of 2013.

SME business – providing a full range of innovative cross-border financial services

The Group strives to enhance the customer experience for SME customers. The Business Integrated Account was optimised to provide different segments of customers with various products and business privileges. The Group continued to enhance its competitive edge in cross-border business through close collaboration with BOC and provided a full range of innovative cross-border financial services to meet the diverse needs of SMEs. The Group also maintained contact with local trade associations and provided them with the latest market information through various economic and business seminars on a regular basis. The BOC Small Business Loan was enhanced with a streamlined application process and a 1-hour preliminary approval service to offer a prompt and flexible financing solution to small businesses. In recognition of its long-standing support of SMEs in Hong Kong, the Group received for the seventh consecutive year the "Best SME's Partner Award" from the Hong Kong General Chamber of Small and Medium Business.

Custody service – further increase of customer base

The Group successfully enlarged its institutional customer base and established business relationships with a number of new RQFII applicants from the Mainland of China, Hong Kong, the Taiwan region and other overseas countries and regions. It also secured mandates from

RQFII-ETFs and various types of RQFII and QDII products. Meanwhile, it further enhanced its service capability through closer collaboration with BOC branches. At the end of June 2014, excluding the RMB fiduciary account for participating banks, total assets under the Group's custody were valued at HK$712 billion.

Cash management service – expanding service coverage

The Group continued to expand its cash management service capabilities. To solidify its competitive advantage in RMB businesses, the Group launched indirect clearing services for UnionPay RMB card issuing institutions, becoming the first bank to provide such services in Hong Kong. In recognition of its outstanding cash management services, BOCHK was presented with the "Achievement Award for Best Cash Management Bank in Hong Kong" by Asian Banker for the second consecutive year. In addition, BOCHK was also awarded the "Hong Kong Domestic Cash Management Bank of the Year" in 2014 by Asian Banking and Finance.

Risk management – proactive measures to contain risks

The Group continued to focus on managing its asset quality by adhering to a prudent credit policy under the principle of "Know Your Customers". It closely monitors the credit position of customers and industries that could be adversely affected by the volatile economic environment, including the possible slowdown of economic growth in the Mainland and withdrawal of stimulus in the US. With regards to the Mainland exposures, the Group maintains vigilance in monitoring customers in certain vulnerable industries with over-capacities. In the trade finance business, the Group focused only on doing business with companies that had a genuine trade background. Rigorous pre- and post-lending monitoring measures were put in place to track early negative signs.

MAINLAND BUSINESS

Financial performance – maintaining healthy growth

The Group's Mainland business maintained healthy growth amid the challenging operating environment. Net operating income increased by 35.8% year-on-year, driven by the strong growth in net interest income and net fee income. Customer deposits and loans registered growth of 0.2% and 4.5% respectively from the end of last year. Slower economic growth on the Mainland placed pressure on certain industries, resulting in an increase in new classified or impaired loans in the first half of 2014. The Group remained focused on managing its asset quality through strict adherence to prudent credit policy and close monitoring of the credit situation.

Product and service offerings – launch of new products in funds distribution and credit card business

The Group continued to enrich its product and service offerings. It enhanced the SME business platform with the launch of Supply Chain Finance, which enables the Group to provide financing services to both upstream and downstream companies in the supply chain. During the period, the Group rolled out QDII-Overseas Fund Products to allow Mainland customers to capture overseas investment opportunities by leveraging the cross-border synergy between Hong Kong and the Mainland of China. Furthermore, it expanded credit card business with the introduction of platinum co-branded credit cards.

Distribution channels – building up electronic platforms

The Group enhanced both its personal and corporate e-Banking platforms with the introduction of new services. It also pressed ahead with the development of several e-platforms to further improve online services and customer experience. The Group's total number of branches and sub-branches in the Mainland of China was 41 at the end June 2014. Meanwhile, the Group continued to expand its branch network in the Mainland of China. NCB (China)'s Suzhou Branch and Shanghai Free Trade Zone Sub-branch commenced business in July 2014.

TREASURY

Financial Results

Treasury recorded a strong increase of 37.0% in profit before taxation.

Net interest income increased by 55.3%, mainly due to the improved average yield on interbank placements coupled with the increase in the related average balance and the improved average yield on debt securities investments. The increase was partly offset by the lower average balance of debt securities investments.

Net trading gain was down 22.4%. The decrease was mainly caused by the mark-to-market changes of certain foreign exchange products and interest rate instruments, which were partly offset by the increased gain from currency exchange transactions.

Net gain on other financial assets was up 39.2% as the Group captured market opportunities to realise gains on certain debt securities investments in the first half of the year.

Business Operation

Proactive investment strategy – enhanced portfolio return while staying attuned to risk

The Group takes a proactive but prudent approach in managing its banking book investments. It closely monitored market changes and adjusted its investment portfolio to enhance return. During the period, the Group increased investments in certain government bonds and selectively increased its holdings in corporate bonds issued by high-quality Mainland and Hong Kong enterprises to improve return. In addition, the Group successfully captured the market opportunity to increase holdings in RMB-denominated bonds issued by policy banks.

Product sales – good growth in RMB foreign exchange related businesses

During the period, the Group took advantage of RMB exchange rate fluctuation to provide value-preservation solutions to its customers. Leveraging its competitive edge in RMB business, the Group launched Preferential RMB structured deposits, which were well received by customers. To provide customers with more potential investment opportunities from the Hong Kong stock market, the Group also launched Basket Equity Linked Investment. This allows customers to enhance their potential return by linking their investment to more than one underlying Hong Kong stock. In bond underwriting business, the business volume soared as the Group successfully captured opportunities from increasing market demand. The Group underwrote the largest offshore RMB corporate bond issuance during the period as the sole global coordinator and joint bookrunner.

Banknotes business – global network expansion

The Group achieved a respectable result in the banknotes business and made progress in enhancing the global banknote distribution network. It completed the first banknotes transaction for a central bank in Central America, marking its success in tapping the banknotes business market in this continent. Meanwhile, the Group continued to establish banknotes business relationships with central banks and BOC's branches in other overseas countries and regions.

RMB clearing business – continuous clearing support

The Group continued to develop better infrastructure to ensure the stable development and continuous improvement of RMB clearing services in both Hong Kong and overseas regions. During the period, the focus was on providing support to BOC's overseas entities, reinforcing the BOC Group's position as the leading provider of clearing services for offshore RMB business in the world.

INSURANCE

Financial Results

The Group's Insurance segment's profit before taxation was HK$278 million in the first half of 2014, down by 50.7%. The decline was mainly caused by a higher provision for insurance liabilities as a result of declining market interest rates. This outweighed the mark-to-market changes of debt securities which were attributable to market interest rate movements.

Net insurance premiums grew robustly by 30.5% as a result of the Group's continuous efforts in product enhancement as well as marketing and promotional campaigns to boost sales volume.

Net interest income grew by 16.9%, which was mainly driven by the expansion of securities investments acquired with the new premiums received.

Business Operation

Driving growth through product enhancement and diversified distribution channels

The Group continued to broaden its product range and actively diversified its distribution channels to reach out to different customer segments. It established partnerships with brokerage firms and launched new products including Wealth-Protector Refundable Accident Insurance Plan, Good Year Cash Coupon Insurance Plan and Plenteous Life Coupon Plan through the Group's different distribution channels. The solid performance enabled BOCG Life to uplift its market ranking to number 1 in the first quarter of 2014, in terms of new business standard premium.

RMB insurance products – a prominent provider

The Group maintained its leading position in the Hong Kong RMB insurance market through product optimisation and innovation. Popular RMB insurance products such as the IncomeGrowth Annuity Insurance Plan, Target 5 Years Insurance Plan Series, RMB Universal Life Insurance Plan, and the recently launched whole life product Plenteous Life Coupon Plan were the major driving force behind the number 1 market ranking BOCG Life attained in RMB insurance business in the first quarter of 2014.

BOCG Life was honoured to receive all the awards in the RMB insurance product category in "RMB Business Outstanding Awards 2014 – Outstanding Insurance Business", organised by Metro Finance, Metro Finance Digital and Hong Kong Wen Wei Po.

OTHERS

Asset management service – making solid progress

BOCHK Asset Management Limited ("BOCHK AM") continued to establish a footprint in the first half of 2014. After obtaining RQFII status and quota in 2013, BOCHK AM received approval from the Securities and Futures Commission of Hong Kong in June and plans to launch RQFII fund investing in onshore equity securities, reinforcing its professional expertise in RMB investment products. The BOCHK All Weather HK & China Equity Fund, a retail fund launched in 2013, performed strongly in terms of asset growth and investment return.

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 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. The Group has a defined risk appetite statement approved by the Board, which is an expression of the types and level of risk that the Group is willing to take in a controllable way in order to achieve its business goals and to meet the expectations of its stakeholders.

Risk Management Governance Structure

The Group's risk management governance structure is designed to cover all business processes and ensures various risks are properly managed and controlled in the course of conducting business. The Group has a robust risk management organisational structure with 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 updated 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 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, approving high-level risk-related policies and monitoring 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 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. The CRO will 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, NCB, NCB (China) and Chiyu, are subject to risk policies that are consistent with those of the Group. Moreover, the Group's non-banking subsidiaries, such as BOCG Life, are subject to the Group's risk management requirements. These subsidiaries are required to formulate their respective risk management policies based on the characteristics of their own industries, perform daily risk management responsibilities and report to BOCHK on a regular basis. Risk management units of BOCHK monitor the risk management status of these subsidiaries.

Credit Risk Management

Credit risk is the risk of loss arising from a customer or counterparty that 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. The Chief Credit Officer, who reports directly to the CRO, takes charge of credit risk management and is also responsible for the control of credit risk exposure of subsidiaries in line with the credit risk management principles and requirements set by the Group.

For advances, different credit approval and control procedures are adopted according to the level of risk associated with the customer, counterparty or transaction. The Credit Risk Assessment Committee, comprising experts from credit and other functions, is responsible for making an independent assessment of material credit which requires the approval of Deputy Chief Executives ("DCE") or above. Credit applications for non-retail exposures are independently reviewed and objectively assessed by risk management units. Obligor ratings (in terms of probability of default) and facility ratings (in terms of loss given default) are assigned to these portfolios to support credit approval. Retail internal rating systems are deployed in the risk assessment of retail credit transactions, including small business retail exposures, residential mortgage loans, personal loans and credit cards. Loan grades, obligor and facility ratings as well as loss estimates (if applicable) are used to support credit approval.

The Group also uses loan grades, obligor ratings and loss estimates (if applicable) to support credit monitoring, reporting and analysis of credit risk information. For non-retail exposures, more frequent rating review and closer monitoring are required for higher-risk customers. For retail exposures, monthly updated internal ratings and loss estimates are used for credit monitoring on a portfolio basis. More comprehensive review is required for obligors being identified under high-risk pools. In the first half of 2014, the Group continues to adopt loan grading criteria which divide credit assets into five 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 ("MC"), RC and Board of Directors to facilitate their continuous monitoring of credit risk. In addition, the Group identifies credit concentration risk by industry, geography, customer and counterparty. The Group monitors changes to counterparties credit risk, quality of the credit portfolio and risk concentrations, and reports regularly to the Group's Management.

The Group employs an internal master rating scale that can be mapped to Standard & Poor's external credit ratings. The structure of internal master rating scale is in compliance with the requirement of the Banking (Capital) Rules under the Hong Kong Banking Ordinance.

For investments in debt securities and securitisation assets, the obligor ratings or external credit ratings, assessment of the underlying assets and credit limits setting on customer/security issuer basis are used for managing credit risk associated with the investment. For derivatives, the Group sets customer limits to manage the credit risk involved and follows the same approval and control processes as applied for advances. On-going monitoring and stop-loss procedures are established. The methodology and assumptions used for impairment assessments are reviewed regularly. In evaluating impairment of asset backed securities ("ABS") and mortgage backed securities ("MBS"), the Group continued to use a significant decline in market price and credit deterioration of the underlying assets to be the key indicators of impairment. The Group also considered other objective evidence of impairment, taking into account the impact of liquidity on market prices and the movement in loss coverage ratios of individual ABS and MBS held by the Group.

Market Risk Management

Market risk refers to the risk of loss arising from movements in the value of foreign exchange, commodity, interest rate and equity positions held by the Group due to the volatility of financial market price (interest rate, foreign exchange rate, equity price, commodity price). The Group adopts a moderate market risk appetite to achieve a balance between risk and return. The Group's objective in managing market risk is to secure healthy growth of the treasury business, by effective management of potential market risk in the Group's business, according to the Group's overall risk appetite and strategy of treasury business on the basis of a well established risk management regime and related management measures.

In accordance with the Group's corporate governance principles in respect of risk management, the Board and RC, senior management and functional departments/units perform their duties and responsibilities to manage the Group's market risk. The RMD (Market Risk Management Division) is mainly responsible for managing market risk, assisting senior management to perform their day-to-day duties, independently monitoring the market risk profile and compliance of management policies and limits of the Group and BOCHK, and ensuring that the aggregate and individual market risks are within acceptable levels.

The Group's market risk management covers BOCHK and its subsidiaries. The Group establishes consistent market risk management policies to regulate BOCHK's and subsidiaries' market risk management; meanwhile, the Group sets up the Group VAR and stress test limits, which are allocated and monitored across the Group, according to the subsidiaries' business requirements and risk tolerance levels. In line with the requirements set in the Group policy, the management of subsidiaries may, subject to prior consent by BOCHK, formulate the detailed policies and procedures and are responsible for managing their daily market risk. The subsidiaries set up independent risk monitoring teams to monitor daily market risk and limit compliance, and submit management information and reports to BOCHK on a regular basis.

The Group sets up market risk indicators and limits to identify, measure, monitor and control market risk. Major risk indicators and limits include but are not limited to VAR, Stop Loss, Open Position, Stress Testing and Sensitivity Analysis (Basis Point Value, Greeks), etc. To meet management requirements, major risk indicators and limits are classified into four levels, and are approved by the RC, MC, CRO and the DCE in charge of the treasury business or the head of the respective business unit, respectively. Treasury business units of BOCHK and subsidiaries (as for Group Limit) are required to conduct their business within approved market risk indicators and limits.

The Group uses the VAR to measure and report general market risks to the RC and senior management on a periodic basis. The Group adopts a uniformed VAR calculation model, using a historical simulation approach and two years of historical market data, to calculate the VAR of the Group and subsidiaries over a 1-day holding period with a 99% confidence level, and sets up the VAR limit of the Group and subsidiaries.

The Group adopts back-testing to measure the accuracy of VAR model results. The back-testing compares the calculated VAR figure of market risk positions of each business day with the actual and hypothetical revenues arising from 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.

Interest Rate Risk Management

Interest rate risk means the risks to a bank's earnings and economic value arising from 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:

- Repricing risk: mismatches in the maturity or repricing periods of assets and liabilities that may affect net interest income;
- Basis risk: different pricing basis for different transactions resulting 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 that may have an adverse impact on net interest income or economic value; and
- Option risk: exercise of the options embedded in assets, liabilities or off-balance sheet items that can cause a change in the cash flows of assets and liabilities.

The Group's risk management framework applies also to interest rate risk management. The Asset and Liability Management Committee ("ALCO") exercises its oversight of interest rate risk in accordance with the "BOCHK Group Banking Book Interest Rate Risk Management Policy" approved by RC. RMD (Interest Rate and Liquidity Risk Management) is responsible for interest rate risk management. With the cooperation of the Asset and Liability Management Division of Financial Management Department and Investment Management, RMD assists the ALCO to perform day-to-day interest rate risk management. Its roles include, but are not limited to, the formulation of management policies, selection of methodologies, setting of risk indicators and limits, assessment of target balance sheet, monitoring of the compliance with policies and limits, and submission of interest rate risk management reports to the senior management and RC, etc.

The Group sets out interest rate risk indicators and limits to identify, measure, monitor and control interest rate risk. The indicators and limits include, but are not limited to, repricing gap limits, basis risk, duration, price value of a basis point ("PVBP"), Greeks, net interest income sensitivity ratio ("NII"), economic value sensitivity ratio ("EV") (including sub-limit for AFS securities), etc. The indicators and limits are classified into three levels, which are approved by the CFO and CRO, ALCO, RC respectively. Risk-taking business units are required to conduct their business within the boundary of the interest rate risk limits. Before launching a new product or business in the banking book, the relevant departments are required to go through a risk assessment process, which includes the assessment of underlying interest rate risk and consideration of the adequacy of current risk monitoring mechanism. Any material impact on interest rate risk noted during the risk assessment process will be submitted to RC for approval.

NII and EV assess the impact of interest rate movement on the Group's net interest income and capital base. They are the Group's key interest rate risk indicators. The former assesses the impact of interest rate movement on net interest income as a percentage to the projected net interest income for the year. The latter assesses the impact of interest rate movement on economic value (i.e. the net present value of cash flows of assets, liabilities and off-balance sheet items discounted using market interest rate) as a percentage to the latest capital base. Limits are set by the RC on these two indicators to monitor and control the Group's banking book interest rate risk.

The Group uses scenario analyses and stress tests to assess the banking book interest rate risk that the Group would face under adverse circumstances. Scenario analyses and stress tests are also used to assess the impact on net interest income and economic value arising from the optionality of savings deposits, the prepayment of mortgage loans and the prepayment of debt securities with embedded options.

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 maintains sound liquidity risk appetite to provide stable, reliable and adequate sources of cash to meet liquidity needs under normal circumstances or stressed scenarios; and to survive with net positive cumulative cash flow in extreme scenarios, without requesting the HKMA to act as the lender of last resort.

The Group's liquidity risk management objective is to effectively manage the liquidity of on- and off-balance sheet items with reasonable cost based on the liquidity risk appetite to achieve sound operation and sustainable profitability. Customer deposits are the Group's primary source of funds. To ensure stable and sufficient source of funds are in place, the Group actively attracts new deposits, keeps the core deposit and obtains supplementary funding from the interbank market or by issuing bills in the capital market. According to different term maturities and the results of funding needs estimated from stressed scenarios, the Group adjusts its asset structure (including loans, bonds investment, interbank placement, etc.) to maintain sufficient liquid assets which provides adequate funds in support of normal business needs and ensure its ability to raise funds at a reasonable cost to serve external claims in case of emergency. The Group is committed to diversify the source of funds and the use of funds to avoid excessive concentration of assets and liabilities and prevent triggering liquidity risk due to the break of funding strand when problem occurred in one concentrated funding source. The Group has established intra-group liquidity risk management guideline to manage the liquidity funding among different entities within the Group, and to restrict their reliance of funding on each other. The Group also pays attention to manage liquidity risk created by off-balance sheet activities, such as loan commitments, derivatives, options and other complex structured products. The Group has an overall liquidity risk management strategy to cover the liquidity management of foreign currency assets and liabilities, collateral, intra-day liquidity, intra-group liquidity, the liquidity risk arising from other risks, etc., and has formulated corresponding contingency plan.

The RC is the decision-making authority of liquidity risk management, and assumes the ultimate responsibility of liquidity risk management. As authorised by RC, ALCO exercises its oversight of liquidity risk and ensures the daily operations of the Group are in accordance with risk appetite and policies as set by RC. RMD (Interest Rate and Liquidity Risk Management) is responsible for overseeing the Group's liquidity risk. It cooperates with the Asset and Liability Management Division of Financial Management Department, Investment Management, etc. to assist the ALCO to perform liquidity management functions according to their specific responsibilities.

The Group established liquidity risk management indicators and limits to identify, measure, monitor and control liquidity risk on daily basis. These indicators and limits include, but are not limited to liquidity ratio, loan to deposit ratio, Maximum Cumulative Cash Outflow ("MCO") and liquidity buffer asset portfolio. The Group applies cash flow analysis to assess the Group's liquidity condition under normal conditions and also performs a liquidity stress test (including institution specific, general market crisis and combined crisis) and other methods at least on monthly basis to assess the Group's capability to withstand various severe liquidity crises. Also, the

Assets and Liabilities Management System is developed to provide data and the preparation for regular management reports to facilitate liquidity risk management duties.

In accordance with the requirements of Supervisory Policy Manual LM-2 "Sound Systems and controls for Liquidity Risk Management" issued by the HKMA in 2011, the Group has implemented in 2013 the refinement on the behaviour model and assumptions of cash flow analysis and stress test to enhance the Group's cash flow analysis under both normal and stressed conditions. In cash flow analysis under normal circumstances, refinements have been made to assumptions relating to on-balance sheet items (such as customer deposits) and off-balance sheet items (such as loan commitments). According to various characteristics of the assets, liabilities and off-balance sheet items, the Group forecasts the future cash flow based on contractual maturity date and the assumptions of customer behaviour and balance sheet changes. In the liquidity stress test, a new combined scenario which is a combination of institution specific and general market crisis has been set up in 2013 to assess the Group's capability to withstand a more severe liquidity crisis, with a more stringent set of assumptions being adopted. Stress test assumptions include the run-off rate of retail, wholesale and interbank deposits; drawdown rate of loan commitments and trade-related contingent liabilities; delinquency ratio and rollover rate of customer loans; and haircut of interbank placement and marketable securities. In addition, the Group has a policy in place to maintain an asset buffer portfolio which includes high quality marketable securities to ensure funding needs even under stressed scenarios. A contingency plan is being established which details the conditions to trigger the plan based on stress test results and early warning indicators, the action plans and relevant procedures and responsibility of various departments.

In certain derivative contracts, the counterparties have right to request from the Group additional collateral if they have concerns about the Group's creditworthiness.

The Group's liquidity risk management also covers new products or business developments. 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 for approval.

The Group has established a set of uniform liquidity risk management policies which serve as standards and guidance to all the Group's members for liquidity risk management. On the basis of the Group's uniform policy, each of the subsidiaries develops its own liquidity management policies according to its own characteristics (subject to approval by BOCHK), and assumes its own liquidity risk management responsibility. Subsidiaries are required to report their respective liquidity positions on a regular basis to RMD (Interest Rate and Liquidity Risk Management) of BOCHK, which consolidates this information and evaluates group-wide liquidity risk.

Operational Risk Management

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

The Group has implemented the "Three Lines of Defence" for its operational risk management. All departments or functional units as the first line of defence are the first parties responsible for operational risk management, and carry out the duties and functions of self risk control in the process of business operation through self assessment and self enhancement. The Operational Risk and Compliance Department ("OR&CD"), together with certain specialist functional units in relation to operational risk management within the Group, including the Human Resources Department, Information Technology Department, Corporate Services Department, Financial Management Department and General Accounting & Accounting Policy Department (collectively known as "specialist functional units"), are the second line of defence. They are responsible for assessing and monitoring the operational risk conditions in the first line of defence, and providing them with guidance. The

OR&CD, being independent from the business units, is responsible for assisting the Management in managing the Group's operational risk, including the establishment and review of the operational risk management policy and framework, designing the operational risk management tools and reporting mechanism, and assessing and reporting the overall operational risk position to the Management and RC. Specialist functional units are required to carry out their managerial duties of the second line of defence with respect to some specific aspects of operational risk and its related issues. 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 group-wide operational risk management. Group Audit is the third line of defence which provides independent assessment to the effectiveness and adequacy of the operational risk management framework and is required to conduct periodic audit of the operational risk management activities of various departments or functional units within the Group regarding their compliance and effectiveness and to put forward recommendations for remedial actions.

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. The Group adheres to the fundamental principle of proper segregation of duties and authorisation. The Group adopts various operational risk management 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 purchase of insurance to mitigate unforeseeable operational risks. Business continuity plans are established 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 decrease. 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 identify and prevent 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 comprehensive framework to continuously monitor reputation risk incidents in the financial industry. This continuous monitoring enables the Group to effectively manage, control and mitigate any potential adverse impact from an incident. The Group also adopts robust disclosure practices to keep our stakeholders informed at all times, which helps build confidence in the Group and establish a strong public image.

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 the Group 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, which reports directly to the CRO. All legal matters are handled by the Legal Services Centre ("LSC"), which reports to the Chief Operating Officer. The 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 the RC as delegated by the Board.

Strategic Risk Management

Strategic risk generally refers to the risks that may cause current or future negative impacts on the earnings, or capital or reputation or market position of the Group because of poor business decisions, improper implementation of strategies and inadequacies in the response to the changing market condition. The Board reviews and approves the strategic risk management policy. Key strategic issues have to be fully evaluated and properly endorsed by the senior management and the Board.

The Group regularly reviews 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 ALCO periodically reviews the Group's capital structure and adjusts the capital mix where appropriate to maintain an optimal balance among risk, return and capital adequacy.

To comply with the HKMA's requirements as stated in the Supervisory Policy Manual "Supervisory Review Process", the Group adopts the internal capital adequacy assessment process ("ICAAP") and reviews it annually. Based on the HKMA's guidelines on Pillar II, ICAAP has been initiated to assess the extra capital needed to cover the material risks not captured or not adequately captured under Pillar I, and therefore minimum Common Equity Tier 1 capital ratio, minimum Tier 1 capital ratio and minimum Total capital ratio are determined. Meanwhile, operating ranges for the aforementioned capital ratios have also been established which enable the flexibility for future business growth and efficiency of capital utilisation.

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 in accordance with the principles stated in the Supervisory Policy Manual "Stress-testing" published by the HKMA. The ALCO monitors the results against the key risk limits approved by the RC. The Financial Management Department reports the combined stress test results of the Group to the Board and RC regularly.

BOCG Life

BOCG Life's principal business is the underwriting of long-term insurance business in life and annuity (Class A), linked long term business (Class C) and retirement scheme management category III (Class I) in Hong Kong. Major types of risk arising from BOCG Life's insurance business are insurance risk, interest rate risk, liquidity risk and credit risk. BOCG 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

BOCG 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 arrangements.

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 BOCG Life's underwriting procedures.

The reinsurance arrangement helps transfer the insurance risk associated with the insurance contracts to the third party. It does not, however, discharge BOCG Life's liability as the primary insurer. If a reinsurer fails to pay a claim for any reasons, BOCG 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 reinsurance contract. BOCG 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. BOCG 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 3.4 to the Interim Financial Information.

Interest Rate Risk Management

An increase in interest rates may result in the depreciation of the value of BOCG 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. BOCG Life manages the matching of assets and liabilities 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. BOCG Life's asset and liability management framework includes cash flow management to preserve liquidity to match policy payout from time to time. In the normal course of BOCG Life's business, new business and in-force policies premiums generate constant cash inflows and, as a result, the portfolios also grow gradually to meet future liquidity requirements.

Credit Risk Management

BOCG Life has exposure to credit 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 BOCG 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)
- Reinsurers' share of insurance unpaid liabilities
- Amounts due from reinsurers in respect of claims already paid
- Amounts due from insurance contract holders
- Amounts due from insurance intermediaries

BOCG 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, BOCG 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.