Chief Executive's Report

The first half of 2003 was highly demanding for Hong Kong's banking sector as a whole. The weak economic and market conditions were further exacerbated by the outbreak of SARS in March. The New Nongkai Loan episode, which occurred at the end of May, has aroused great concern about our Group's risk management system and corporate governance. The Board then proactively adopted a series of measures to address the issues and has gained full support from our management and staff during the course of their execution. Against this backdrop, we continued to develop our business in accordance with our strategy, streamline our operation in order to achieve higher cost-efficiency, and improve the diversity and quality of our service to meet customers' needs. We also continued to focus on delivering our promises to shareholders at the time of our IPO and creating long-term shareholder value.

Half-year Performance

For the six months to 30 June 2003, the Group's operating profit before provisions was HK$6,139 million, up 2.28%, whereas operating profit after provisions was HK$4,470 million, up 5.52%. Profit attributable to shareholders was HK$3,012 million, a decrease of 11.80%. Earnings per share stood at HK$28.49 cents.

Notwithstanding the adverse economic environment, our business operations remained stable and we were able to continue with product and service innovation and explore opportunities for business development. Higher operating profit in the first half of the year was mainly attributable to the growth in other operating income and cost containment.

As a result of the growth in wealth management income and profit from treasury operations, our other operating income increased by 12.04% to HK$2,252 million. Leveraging our distribution channels, which have been integrated and strengthened under the BOCHK brand name after our restructuring and merger, we were able to increase our wealth management income, including income from the distribution of insurance products and fees from the sales of investment funds and retail bonds. By optimising our investment portfolio and launching new treasury products and services, net gains from other investments in securities, foreign exchange and dealing activities increased by 36.76% in the highly volatile markets.

These were offset by the decrease in net interest income of 4.46% to HK$6,584 million. Net interest margin decreased by 10 basis points resulting from a reduction of 6 basis points in net interest spread and a decrease of 4 basis points in the contribution from net free funds in the low interest rate environment.

On the other hand, we continued to streamline operating expenses, thereby achieving better cost efficiency. During the interim period, operating expenses decreased by 6.97% as a result of a reduction in staff costs by 7.21%. The total number of employees, including all the subsidiary companies, was 13,020 at 30 June 2003, compared to 13,439 at 31 December 2002. Savings from the reduction in rental expenses and from consolidation of business operations also helped to improve efficiency across the board. The cost to income ratio decreased by 2.05 percentage points to 30.52% for the first half of 2003, one of the lowest in the industry.

While the credit environment in Hong Kong remained one of the greatest concerns for the banking industry, the credit quality of our loan portfolio continued to improve and contribute to our profit. Net charge for bad and doubtful debts decreased by 5.49% to HK$1,669 million. New specific provisions for the Group decreased, reflecting the improvement in the overall quality of the loan portfolio despite additional provisions made for collateral devaluation and the negative impact of SARS.

The NPL ratio improved from 7.99% at 31 December 2002 to 7.80% at 30 June 2003 — a result of credit controls, bad debt collection efforts and write-offs. We continued to maintain a high coverage for NPLs. The loan loss reserve ratio increased to 60.56%. The specific provisions and collateral coverage ratio for classified loans also increased to 90.87% at 30 June 2003.

After provisions, our operating result improved by 5.52%. However, the Group's overall results inevitably reflected the prevailing property market conditions, like other local banks.

During this period, we incurred a revaluation loss of HK$1,223 million on premises and investment properties. While the cost of our revaluation is not out of the norm, its impact on our profit attributable to shareholders is much more dramatic because little property revaluation reserves are available for offset against the fall in market value of the properties concerned as a result of the restructuring and merger on 1 October 2001. We will continue to review our portfolio of properties and make necessary adjustments in accordance with the Group's accounting policies.

Chief Executive's Report (continued)

Half-year Performance (continued)

For these main reasons, profit before taxation decreased by 22.94% to HK$3,245 million. After the write-back of a tax over-provision, the Group's profit attributable to shareholders during the first half of 2003 decreased by 11.80% to HK$3,012 million.

The Group's financial positions remained strong. Our capital and liquidity were maintained at high levels. Total capital ratio was 14.66% and tier-one capital ratio was 13.76%, compared to 13.99% and 13.12% respectively at the last year-end. The average liquidity ratio was 37.93% for the 2003 interim period, compared with 41.26% for the 2002 interim period.

Business Review

In the period under review, we continued to concentrate on business development and implement our strategic initiatives.

Our customer-focused banking services were enhanced through innovative and flexible product development as well as intensive staff training. Cross-selling efforts increased within our broad-based distribution network and across all business and customer segments. Cost efficiency was enhanced through business re-engineering, operations streamlining and the rationalisation of human resources. Our NPL ratio continued to decrease. The quality of residential mortgage loans and credit card advances improved. The risk profile of our asset mix was adjusted through increases in investments in securities and greater diversification in lending. We also continued to invest in technologies for sustainable business development and risk management improvement.

Retail banking

In the prevailing low interest rate environment, the demand for wealth management products remained strong. Capitalising on our extensive distribution capability and focusing our marketing efforts, we achieved an overall income growth of approximately 3.6 times in the distribution of life insurance products as new insurance plans were launched to meet the diverse needs of our customers. Besides, guaranteed funds continued to be well received by the market and we also registered satisfactory results in the sale of open-ended funds.

As a major mortgage service provider, we continued to provide innovative mortgage products catering to customers with unique financial needs. Several new products, such as One-Stop Mortgage Insurance Programme and Smart Mortgage Insurance Programme, were introduced during the period and more will follow in the near future as we extend our reach.

Owing to a more effective credit management process, the quality of our residential mortgage portfolio continued to improve with the delinquency ratio, including rescheduled loans, dropped from 1.75% to 1.51%. Our credit card charge-off ratio also fell to 10.25% in the first half of 2003 from 12.33% in 2002, lower than the industry average.

The number of new Great Wall International Card and Great Wall Renminbi Card issued during the period grew substantially. Great Wall International Card increased its number of new cards issued and cardholder spending by 60% and 61% respectively over the same period last year. This card is specifically designed for Mainland customers who frequently travel and transact outside the country. There has also been a strong demand for Great Wall Renminbi Card, targeted at Hong Kong people who frequently travel to the Mainland. The number of new Great Wall Renminbi Card issued grew approximately 10 times compared to the first half of 2002.

Corporate banking & financial institutions

We continued to consolidate our position as a leader in the local syndication market as we played an active role in arranging syndicated lending for blue-chip companies. In addition, we arranged syndicated loans for Hong Kong-listed companies and Mainland state-owned companies.

Asset quality improved as we increased lending to counter-cyclical sectors, such as utilities, and our exposure to the property investment sector reduced. Furthermore, we strove to increase the lending to local SMEs by actively broadening our SME loan product offering.

Chief Executive's Report (continued)

Business Review (continued)

Corporate banking & financial institutions (continued)

New treasury products were rolled out to facilitate asset and liability management of our corporate customers. We also strengthened our position with other financial institutions, as we became one of the first local banks to participate in the Transferable Loan Certificate Subprogram of the Debt Issuance Program of the Hong Kong Mortgage Corporation Limited. Furthermore, we were appointed as the clearing bank in Hong Kong for several Mainland financial institutions. During the period, we entered into a cooperation agreement with BOC that is expected to give further impetus to grow our business with Mainland financial institutions.

Treasury operations

Notwithstanding the impact of the war in Iraq, SARS and the uncertainties of the US economy on global financial markets, we continued to optimise our investment portfolio, launch successful new products and contribute to our interim results.

We continued to enhance our service quality and broaden our product range. We provided bond trading services, equity-linked deposits and structured deposits to fulfil various investment preferences of our customers. We also extended foreign exchange trading hours, thus growing the number of customers and trading volume in the first half of 2003.

Mainland branches and China-related business

Last year, we established the China Business Head Office to coordinate and manage our Mainland branches. As a result, overall operating efficiency and business development improved. The operating profit before provisions of our Mainland branches increased by about 37%.

During the first half of 2003, three more of our branches and sub-branches in Shenzhen were authorised to offer Renminbi services. We now operate Renminbi business in eight locations in four Mainland cities.

In January, BOCHK and BOC jointly launched BOC Prestige Banking, a premier one-stop banking service designed exclusively for customers who frequently travel between Hong Kong and the Mainland.

Channels, technologies and operations

We continued to consolidate branches in order to maximise the utilisation of resources and achieve cost efficiency. As at 30 June 2003, we had 305 branches in Hong Kong, compared to 319 at the end of 2002. We also opened new service centres in selected areas in order to optimise our distribution network and capitalise on new business opportunities. e-Banking is vital to our rationalisation and expansion efforts. Since the end of 2002, the number of iT's Online Banking customers has increased by about 30%. Our efforts to optimise our network through technology and process improvement are on track and will proceed further.

The implementation of key components of our Information Technology Development Blueprint marked a key step in delivering the promise of major technology infrastructure upgrades. With the introduction of a new Customer Relationship Management System, we will be able to enhance our capability to provide premier services and products to customers. Management Control System, a new platform for the provision of management information, will enable us to manage risk better, to evaluate performance and to formulate sound strategies.

Chief Executive's Report (continued)

The Future and the Strategies

Moving ahead, we believe that there are new opportunities for the banking sector as a whole in the foreseeable future. The implementation of CEPA means the economic relationship between Hong Kong and the Mainland of China will be further strengthened for mutual gains, which is conducive to long-term growth. Strong in financial and business services, logistics and tourism, Hong Kong is well positioned to benefit from this development.

For BOCHK, we anticipate a growth in demand for banking services from enterprises that are establishing a firmer foothold in the Mainland after CEPA. It is likely that there will be more opportunities in trade financing and wealth management after CEPA and as China fulfils her obligations as a member of the World Trade Organisation.

We also believe it will be a positive factor for Hong Kong's banking sector should the offering of Renminbi banking services be allowed here. In collaboration with BOC, we will further enhance cross-border and integrated financial services to our customers to further strengthen our operations in the Mainland.

In the immediate future, with the SARS outbreak behind us, there are signs that the local economy is stabilising gradually, led by retail spending and tourism. Externally, we believe strong economic growth in the Mainland, coupled with the stabilised economic prospects in the US, would also be conducive to the improvement of Hong Kong's business environment. However, the second half of 2003 is still expected to be under the impact of deflation, margin pressure, slow consumption and subdued loan demand as well as high unemployment rate.

Under the circumstances, wealth management will remain one of our key initiatives in view of its promising growth potential. We will continue to pursue the cross-selling potential of our customer base through our extensive distribution network. Effective performance incentive and intensive staff training will be implemented to drive our cross-selling efforts.

Besides, consumer lending will continue to be our key focus in the future for it can help balance our loan portfolio. We will enhance our card business through service development and technology improvements. As the market sentiment improves, we expect residential mortgage lending will continue to grow and our strategy is to provide value-added services and products to our customers.

Should the economies of the US and Hong Kong recover at a faster pace in the second half of 2003, we believe business activities would increase as well. Trade finance will be the focus of our corporate banking business in the near future. Our aim is to serve the needs of corporate customers in trade payment and trade services.

SMEs represent an increasingly important segment of our corporate customers. We believe the establishment of the commercial credit reference agency in Hong Kong in the near future will facilitate the development of SME lending business. Committed to our customer-focused strategy, we are positioning ourselves to be one of the best providers of SME financial services in terms of flexibility and product range.

We understand that technology differentiates premier banking services. We are therefore committed to building the best electronic distribution channels for our customers. By leveraging our current technology infrastructure and through system enhancement, we aim to increase the use of our electronic distribution channels by our customers.

At the same time, we will continue to better manage cost through process re-engineering, branch network rationalisation and continuous implementation of our Information Technology Development Blueprint.

To the list of challenges we encountered in the last few months was added the New Nongkai Loan episode. The management and staff have been cooperating fully with the Special Committee and professional advisers in their investigations, and ensuring that business remained as usual during the process. As a forward-looking corporation, we are wholly committed to implementing the recommendations of the Special Committee in order to further improve our credit approval process, risk management and internal control procedure. We are also determined to further enhance our corporate governance framework and transparency. We firmly believe that having gone through this enlightening process, the experience gained will make us even more mature and prudent as we move ahead in a more proactive and aggressive manner.

Chief Executive's Report (continued)

The Future and the Strategies (continued)

As the new Chief Executive, I am working very closely and wholeheartedly with my colleagues towards the Group's vision to be one of the premier banks in the region. After our restructuring and listing, with the Board's guidance and the support of various professional consultants, we have introduced a new operating system and control mechanism in line with the best international banking practices. As we move forward, we will continue to fine-tune and adjust our system and mechanism to ensure the highest standards of quality are maintained. Of equal importance is the need to advance our corporate culture and clearly define our Group's vision, mission and values. Meanwhile, we are working hand in hand with all our staff to implement all these important changes and to ensure that the interests of individuals will be aligned with those of the Company and shareholders. I am confident that the infrastructure and the people that we have will enable us to overcome the challenges we face, create better opportunities for the Group and deliver superior value to our shareholders in the long term.

HE Guangbei
Chief Executive
Hong Kong, 5 September 2003