

Financial Review

Financial Performance

Summary of Operating Results

	Half-year ended 30 June 2003 HK\$'m	(Unaudited) As restated Half-year ended 30 June 2002* HK\$'m
Operating profit before provisions	6,139	6,002
Operating profit after provisions	4,470	4,236
Profit before taxation	3,245	4,211
Profit attributable to shareholders	3,012	3,415
Earnings per share (HK\$ cents)	28.49	32.30
Return on average total assets (annualised)**	0.82%	0.94%
Return on average shareholders' funds (annualised)	10.56%	13.01%

* Certain figures for 2002 have been restated to reflect the adoption of SSAP 12 (revised) "Income taxes".

** The calculation of average balance of total assets is refined by using daily exchange rates.

The Group's profit attributable to shareholders amounted to HK\$3,012 million, a decrease of HK\$403 million, or 11.80%, from the first half of 2002, which was mainly due to the loss from revaluation of premises and investment properties partly offset by the write-back of a tax over-provision. Operating profit before provisions increased by HK\$137 million, or 2.28%, to HK\$6,139 million. Earnings per share were HK\$28.49 cents, down HK\$3.81 cents from the first half of 2002. Return on average total assets fell by 0.12 percentage point to 0.82% and return on average shareholders' funds was 10.56%, a decline of 2.45 percentage points against 13.01% for the first half of 2002.

Net Interest Income

	Half-year ended 30 June 2003 HK\$'m	(Unaudited) Half-year ended 30 June 2002 HK\$'m
Interest income	9,358	10,958
Interest expense	(2,774)	(4,067)
Net interest income	6,584	6,891
Average interest-earning assets [#]	701,544	698,313
Net interest spread (annualised) [#]	1.79%	1.85%
Net interest margin (annualised) [#]	1.89%	1.99%

[#] The calculations of average balance of interest-earning assets and interest-bearing liabilities are refined by using daily exchange rates.

Net interest income fell by HK\$307 million, or 4.46%, to HK\$6,584 million, mainly attributable to the narrowing of spreads on lending and the fall in contribution from net free funds as a result of lower market interest rates. Average interest-earning assets increased by HK\$3,231 million, or 0.46%, to HK\$701,544 million. Net interest margin fell by 10 basis points, which was the combined effect of a reduction of 6 basis points in net interest spread and a reduction of 4 basis points in the contribution from net free funds.

Financial Review (continued)

Financial Performance (continued)

Net Interest Income (continued)

Contribution from debt securities increased due to the redeployment of funds to debt securities from lower yielding short-term funds and interbank placements. Growth in low-cost savings deposits contributed to the lower funding cost. These positive effects, however, were offset by a decline in the average loan yield, mainly caused by a reduction in the best lending rate and the narrowing of spreads from intense market competition.

Other Operating Income

	Half-year ended 30 June 2003 HK\$m	(Unaudited) Half-year ended 30 June 2002 HK\$m
Fees and commission income	1,690	1,705
Fees and commission expenses	(313)	(357)
Net fees and commission income	1,377	1,348
Dividend income from investments in securities	31	11
Net gain from other investments in securities	156	70
Net gain from foreign exchange activities	478	402
Net gain from other dealing activities	17	4
Net rental income from investment properties	88	93
Others	105	82
Other operating income	2,252	2,010

Other operating income increased by HK\$242 million, or 12.04%, to HK\$2,252 million, accounting for 25.49% of total operating income compared to 22.58% for the first half of 2002.

Net fees and commission income amounted to HK\$1,377 million, an increase of HK\$29 million, or 2.15%. This mainly reflected lower cash rebates for residential mortgage loans, a result of a fall in new mortgage loans made during the period.

Income from wealth management includes income from the distribution of insurance products, commissions on sales of investment funds, retail bonds and securities transactions executed for customers. There was a strong growth in wealth management income from the distribution of life insurance products. Other key positive factors for fees and commission income included increases in income from levy on low-balance Hong Kong dollar savings accounts and from continuous growth in payment services. However, these were offset by a reduction in loans related fee income.

Net gain from other investments in securities increased by HK\$86 million, or 122.86%, to HK\$156 million, mainly due to marked-to-market gains on debt securities. Owing to the increases in transaction volume and premium income from foreign exchange activities, net gain from foreign exchange activities rose to HK\$478 million, an increase of HK\$76 million, or 18.91%.

Financial Review (continued)

Financial Performance (continued)

Operating Expenses

	Half-year ended 30 June 2003 HK\$'m	(Unaudited) Half-year ended 30 June 2002 HK\$'m
Staff costs	1,634	1,761
Premises and equipment expenses (excluding depreciation)	309	360
Depreciation on owned fixed assets	322	359
Other operating expenses	432	419
Operating expenses	2,697	2,899

Operating expenses decreased by HK\$202 million, or 6.97%, to HK\$2,697 million, mainly due to a decrease in average headcount as well as continued emphasis on cost reduction throughout the Group. The cost to income ratio lowered by 2.05 percentage points to 30.52% for the first half of 2003, benefiting from productivity and operating efficiency improvements.

Staff costs fell by HK\$127 million, or 7.21%, to HK\$1,634 million. As a result of the decrease in rental expenses and the benefits from the rationalisation of business operations, premises and equipment expenses declined by HK\$51 million, or 14.17%, to HK\$309 million. These positive factors, however, were partly offset by increase in information technology expenses.

Charge for Bad and Doubtful Debts

	Half-year ended 30 June 2003 HK\$'m	(Unaudited) Half-year ended 30 June 2002 HK\$'m
Specific provisions		
— new provisions	2,537	3,289
— releases	(482)	(1,173)
— recoveries	(220)	(350)
	1,835	1,766
General provisions	(166)	—
Net charge to profit and loss account	1,669	1,766

The net charge for bad and doubtful debts decreased by HK\$97 million, or 5.49%, to HK\$1,669 million, while the ratio to average gross advances to customers declined by 0.08 percentage point to 1.04% for the first half of 2003. New specific provisions decreased by HK\$752 million, or 22.86%, to HK\$2,537 million, which was a result of an overall improvement in loan quality after the Group's June 2002 loan sale, partly offset by increase in provisions for collateral devaluation and the impact of SARS. Specific provision releases reduced by HK\$691 million, or 58.91%, to HK\$482 million. Recoveries also fell by HK\$130 million, or 37.14%, to HK\$220 million, reflecting the difficulties in recovering and collecting bad debts amid the lacklustre economic environment.

Financial Review (continued)

Financial Performance (continued)

Net Loss from Revaluation of Fixed Assets

To reflect the decline in property value in Hong Kong in the first half of 2003, a revaluation of the Group's premises and investment properties was performed at 30 June 2003. All investment properties were revalued on the basis of their open market values by Chesterton Petty Limited, an independent professional valuer, resulting in a charge to the profit and loss account of HK\$494 million in the first half of 2003. The Group had regard to the independent professional valuations carried out on a majority of the premises by the valuer. The revaluation of the Group's premises resulted in a charge to the profit and loss account of HK\$729 million in the first half of 2003 and a decrease in the premises revaluation reserve of HK\$49 million.

Financial Position

Balance Sheet Summary

	At 30 June 2003 HK\$m	As restated At 31 December 2002* HK\$m
Total assets	735,494	735,536
Cash and short-term funds	94,830	115,075
Placements with banks and other financial institutions maturing between one and twelve months	91,688	80,159
Certificates of deposit held	18,795	17,528
Investments in securities	167,636	158,633
Advances and other accounts	308,847	308,332
Fixed assets	17,921	20,212
Total liabilities	677,010	677,751
Deposits from customers	585,135	600,977
Total capital resources	58,484	57,785
Shareholders' funds	57,367	56,671

* Certain figures for 2002 have been restated to reflect the adoption of SSAP 12 (revised) "Income taxes".

Total assets amounted to HK\$735,494 million at 30 June 2003, a decrease of HK\$42 million, or 0.01%, from HK\$735,536 million at 31 December 2002.

Short-term funds were reduced and redeployed into higher yielding debt securities. Investments in securities rose by HK\$9,003 million, or 5.68%, to HK\$167,636 million at 30 June 2003 from HK\$158,633 million at 31 December 2002. Approximately 95% of securities holdings will mature within five years and approximately 71% of them were issued by banks and other financial institutions.

Advances to customers increased slightly by HK\$147 million, or 0.05%, from HK\$321,034 million at 31 December 2002 to HK\$321,181 million at 30 June 2003. Excluding the write-offs of HK\$1,732 million, the advances to customers would have grown by 0.59%. Corporate loans used in Hong Kong (including trade finance) increased by 1.80%, mainly in the transport, utilities and property development sectors. These growths were partly offset by decline in lending to the property investment sector and for the purchase of residential properties. Residential mortgage loans, including those under the Home Ownership Scheme and other government sponsored home purchasing schemes, decreased by HK\$2,024 million, or 1.91%, to HK\$103,785 million at 30 June 2003 from HK\$105,809 million at 31 December 2002.

Financial Review (continued)

Financial Position (continued)

Balance Sheet Summary (continued)

Fixed assets amounted to HK\$17,921 million at 30 June 2003, a decrease of HK\$2,291 million, or 11.33%, from HK\$20,212 million at 31 December 2002. The decline was primarily due to the disposal of premises and investment properties of HK\$730 million, deficits on revaluation of premises and investment properties of HK\$1,272 million and depreciation charges. Major disposal during the period included Kincheng Bank Building and Sin Hua Bank Centre.

Total liabilities decreased by HK\$741 million, or 0.11%, to HK\$677,010 million at 30 June 2003 from HK\$677,751 million at 31 December 2002.

Deposits from customers decreased from HK\$600,977 million at 31 December 2002 to HK\$585,135 million at 30 June 2003, a fall of HK\$15,842 million, or 2.64%, reflecting our effective liability management. Customers continued to shift funds to savings deposits from time deposits under the low interest rate environment. Savings deposits rose by 10.63% and time, call and notice deposits declined by 9.81%.

The loans to deposits ratio rose by 1.47 percentage points to 54.89% at 30 June 2003, the effect of a marginal growth in customer advances against a decline in customer deposits.

Asset Quality

	At 30 June 2003 HK\$'m	At 31 December 2002 HK\$'m
Advances to customers	321,181	321,034
General provisions	(6,197)	(6,363)
Specific provisions	(8,973)	(8,650)
Non-performing loans	25,049	25,659
Specific provisions made in respect of non-performing loans	(8,452)	(8,637)
Non-performing loans as a percentage of advances to customers	7.80%	7.99%
Specific provisions as a percentage of non-performing loans	33.74%	33.66%
Loan loss reserve ratio	60.56%	58.51%
Residential mortgage loans*		
Delinquency** and rescheduled loan ratio	1.51%	1.75%
Card advances		
Delinquency ratio**	1.28%	1.34%
Charge-off ratio (annualised)	10.25%	12.33%

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

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

Financial Review (continued)

Financial Position (continued)

Asset Quality (continued)

During the first half of 2003, Hong Kong's credit environment remained one of the greatest concerns for the banking industry. However, our non-performing loan ratio continued to improve, reducing from 7.99% at 31 December 2002 to 7.80% at 30 June 2003, attributable to our stringent credit controls, collection of bad debts and write-offs. The classified loan ratio also lowered from 7.98% at 31 December 2002 to 7.80% at 30 June 2003. During the period, low NPL formation, recoveries, and write-offs made up an improvement in asset quality. During the first half of 2003, approximately HK\$2,924 million of classified loans were recovered through cash collections and collateral disposal, and HK\$1,732 million of bad debts were written off.

Specific provisions as a percentage of non-performing loans increased from 33.66% at 31 December 2002 to 33.74% at 30 June 2003. The loan loss reserve ratio also rose from 58.51% at 31 December 2002 to 60.56% at 30 June 2003. The specific provisions and collateral coverage ratio for classified loans was 90.87%, compared with 90.08% at 31 December 2002.

The quality of the Group's residential mortgage portfolio improved. The combined delinquency and rescheduled loan ratio decreased from 1.75% at 31 December 2002 to 1.51% at 30 June 2003, which was better than the market average of 1.65%.

The quality of credit card advances also improved. The delinquency ratio fell from 1.34% at 31 December 2002 to 1.28% at 30 June 2003. The charge-off ratio decreased from 12.33% for the year 2002 to 10.25% for the first half of 2003, mainly due to the Group's effective credit controls.

Financial Review (continued)

Financial Position (continued)

Capital Management and Liquidity

	At 30 June 2003 HK\$'m	At 31 December 2002* HK\$'m
Tier 1 capital	55,689	54,357
Tier 2 capital	5,077	5,200
Unconsolidated investments and other deductions	(1,408)	(1,572)
Total capital base after deductions	59,358	57,985
Risk-weighted assets		
On-balance sheet	366,439	369,345
Off-balance sheet	39,699	46,624
Deductions	(1,362)	(1,572)
Total risk-weighted assets	404,776	414,397
Total risk-weighted assets adjusted for market risk	399,268	402,997
Capital adequacy ratios		
Before adjusting for market risk		
Tier 1	13.76%	13.12%
Total	14.66%	13.99%
After adjusting for market risk		
Tier 1**	13.95%	13.49%
Total**	14.87%	14.39%
	Half-year ended 30 June 2003	Half-year ended 30 June 2002
Average liquidity ratio	37.93%	41.26%

* Prior year comparatives have not been restated on adoption of SSAP 12 (revised) "Income taxes".

** The capital ratios taking into account market risks are calculated in accordance with the relevant HKMA guideline.

The Group's capital strength remained robust. The consolidated capital adequacy ratio increased from 13.99% at 31 December 2002 to 14.66% at 30 June 2003. Capital base grew by 2.37% while unadjusted risk-weighted assets fell by 2.32%. The increase in capital base was due to an increase in retained profits. The decrease in risk-weighted assets was mainly attributable to a decrease in contingent liabilities and commitments.

The Group maintained a strong liquidity position with the average liquidity ratio of 37.93%, 3.33 percentage points lower than 41.26% for the first half of 2002.