INNOVATIVE **RMB**
SERVICE

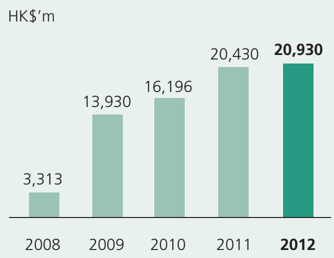
MANAGEMENT'S DISCUSSION AND ANALYSIS

FINANCIAL PERFORMANCE AND CONDITION AT A GLANCE

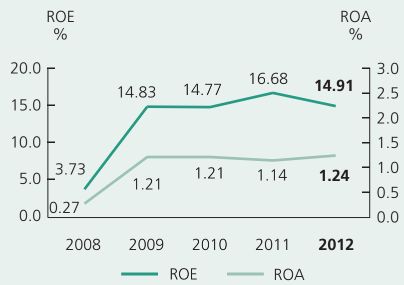
The Group achieved another set of encouraging financial results in 2012 with profit attributable to the equity holders reaching a new high. The financial position remains solid with key financial ratios at healthy levels.

Key Performance Trends

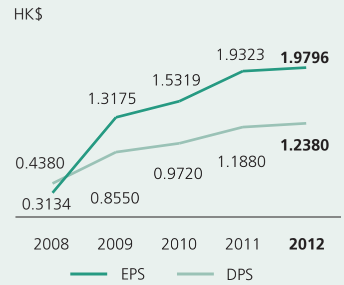
Profit Attributable to the Equity Holders



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



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



Profit attributable to the equity holders reaching new high

- Profit attributable to the equity holders increased by 2.4% year-on-year to HK$20,930 million, a record high since listing. Excluding the impact of Lehman Brothers-related products[3], it would have increased by 14.9%.

Solid return with sustainable growth

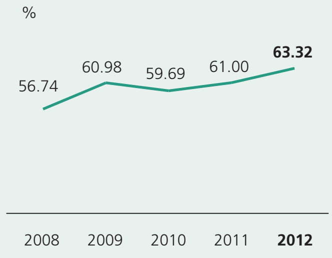
- ROE was 14.91%. Excluding the impact of Lehman Brothers-related products, ROE would have been 14.74%, up 0.19 percentage point year-on-year.
- ROA was 1.24%. Excluding the impact of Lehman Brothers-related products, ROA would have remained at 1.24%, up 0.23 percentage point year-on-year.

Consistent return to shareholders

- EPS rose to HK$1.9796. DPS was HK$1.238, increasing by 4.2% year-on-year.

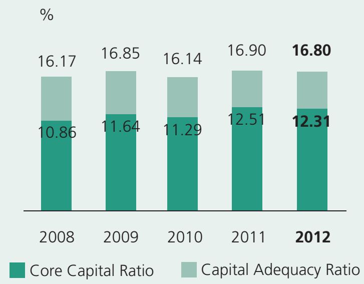
Financial Position

Loan-to-Deposit Ratio[4]



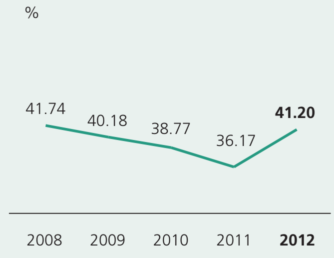
* as at 31 December

Capital Adequacy Ratio[5]



* as at 31 December

Average Liquidity Ratio[6]



Satisfactory loan and deposit growth

- Advances to customers increased by 11.3% while deposits from customers rose by 7.2%. Loan-to-deposit ratio was 63.32%.

Solid capital position to support business growth

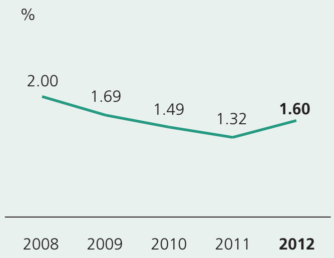
- CAR was 16.80%, while core capital ratio stood at 12.31%.

Sound liquidity position

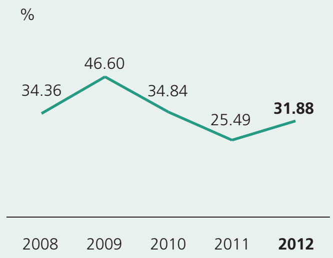
- Average liquidity ratio improved to 41.20%.

Key Operating Ratios

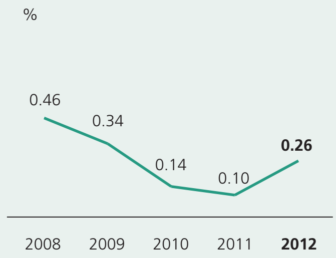
Net Interest Margin ("NIM")



Cost-to-Income Ratio



Classified or Impaired Loan Ratio[7]



* as at 31 December

Significant improvement in NIM

- NIM was 1.60%, up 28 basis points year-on-year with improved loan pricing and return on offshore RMB business as well as an eased diluting effect by the RMB clearing bank[8] business.

Effective cost control

- Cost-to-income ratio was 31.88%, among the lowest in the industry. Excluding the impact of Lehman Brothers-related products, it would have fallen by 2.41 percentage points year-on-year.

Classified or impaired loan ratio at a low level

- Classified or impaired loan ratio stood at a sound level of 0.26%, below the market average.

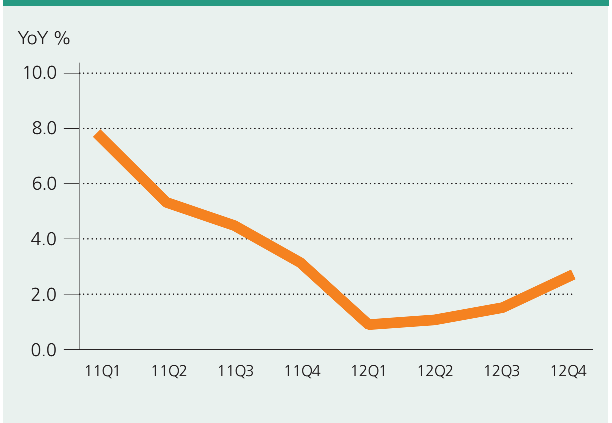
1. Return on Average Shareholders' Equity as defined in "Financial Highlights".
2. Return on Average Total Assets as defined in "Financial Highlights".
3. The net amount of HK$97 million recovered by the Group in 2012 from the underlying collateral of the Lehman Brothers Minibonds was credited to operating expenses (2011: HK$2,854 million). The net recovery together with the expenses of Lehman Brothers-related products is referred to as "impact of Lehman Brothers-related products" in the Management's Discussion and Analysis.
4. The deposit base also includes structured deposits reported as "Financial liabilities at fair value through profit or loss".
5. Capital adequacy ratio is computed on the consolidated basis that comprises the positions of BOCHK and certain subsidiaries specified by the HKMA for its regulatory purposes and in accordance with the Banking (Capital) Rules. The bases of regulatory capital calculation for credit risk, market risk and operational risk are described in Note 4.5 to the Financial Statements in this Annual Report.
6. The average liquidity ratio is calculated as the simple average of each calendar month's average liquidity ratio of BOCHK for the year.
7. Classified or impaired loans follow the definitions set out in the Banking (Disclosure) Rules under the Banking Ordinance and represent advances which are either classified as "substandard", "doubtful" or "loss" under the Group's classification of loan quality, or individually assessed to be impaired.
8. Since December 2003, the Bank has been appointed as the clearing bank to provide RMB clearing services in Hong Kong.

MANAGEMENT'S DISCUSSION AND ANALYSIS

ECONOMIC BACKGROUND AND OPERATING ENVIRONMENT

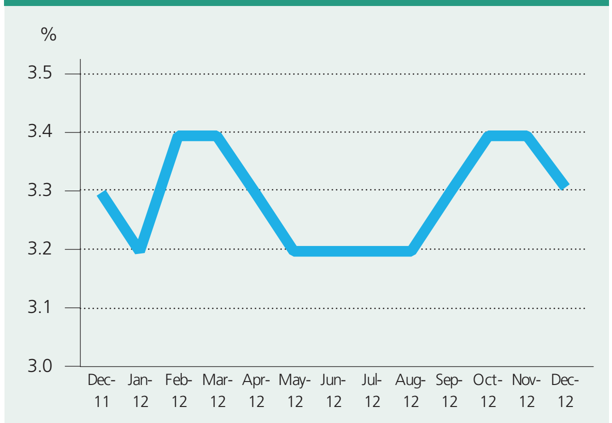
In 2012, the operating environment for Hong Kong's banking industry remained tough. The European debt crisis and the slow recovery of the US economy continued to weigh on the global economy. Economic fundamentals of the Eurozone further deteriorated, although the debt crisis stabilised as the European Central Bank pledged to save the Euro currency. Weak household balance sheets and growing fiscal uncertainties continued to hinder the growth in the US. In view of sluggish demand and high unemployment, the Federal Reserve extended its Operation Twist programme in June and announced an open-ended quantitative easing in September. Market interest rates remained at an extremely low level. On a positive note, the Mainland economy saw cyclical recovery from the marked slowdown earlier in the year with respective growth recorded in industrial production, investment and consumption.

Hong Kong Real GDP Growth Rate



Source: HKSAR Census and Statistics Department

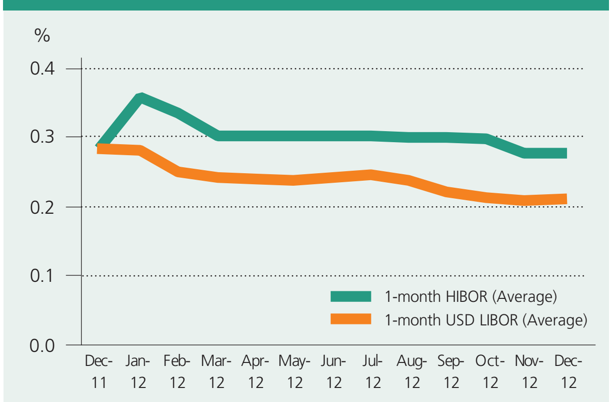
Hong Kong Unemployment Rate



Source: HKSAR Census and Statistics Department

Notwithstanding subdued external demand, the Hong Kong economy continued to grow at a modest pace. The GDP growth in 2012 was 1.4%. The unemployment rate remained at a low level. Inflationary pressure moderated, with the Composite CPI rising by 4.1% year-on-year in 2012.

HIBOR and USD LIBOR



Source: Bloomberg

The low interest rate environment in Hong Kong continued amid the ongoing accommodative monetary policy in the US. Average 1-month HIBOR and USD LIBOR fell slightly from 0.29% and 0.28% in December 2011 to 0.28% and 0.21% respectively in December 2012.

Investment sentiment in the Hong Kong stock market weakened in the first half in view of the deteriorating external environment. Nevertheless, with additional easing measures adopted by the US and the likely pick-up of economic growth in the Mainland, market sentiment improved in the fourth quarter. The Hang Seng Index reached the lowest point of the year at 18,186 in June and closed at 22,657 at the end of 2012, up 22.9% on a yearly basis.

The local residential property market was buoyant since March 2012. The up-tick in the property market prompted the government to implement stabilising measures, including further tightening of mortgage criteria, raising Special Stamp Duty rates and extension of the restriction period. As a result, the level of transaction activity moderated towards the end of the year with the number of agreements for sale and purchase for residential building units in 2012 registering a decline over 2011. Meanwhile, the average price of private domestic properties showed a further increase from 2011.

During the year, the offshore RMB business in Hong Kong continued to expand. A series of initiatives were announced to support the development of the business. These included the further relaxation of investment restrictions in relation to the RMB Qualified Foreign Institutional Investors ("RQFII") scheme, the expansion of RMB services to non-Hong Kong residents and the introduction of the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone ("Qianhai Cooperation Zone"), a new financial and commercial hub between the Mainland and Hong Kong. From a regulatory perspective, the HKMA revised regulations to enhance the liquidity of the offshore RMB market in Hong Kong. These changes provided banks with more business opportunities and allowed them additional flexibility and liquidity to facilitate offshore RMB transactions.

In summary, the operating environment for the banking industry was highly challenging in 2012. Local economic growth was weak and market competition intensified. Improvement of banks' net interest margin was also restrained by the low interest rate environment. Nevertheless, the further expansion of the offshore RMB business continued to present business opportunities to the banking sector.

Outlook for 2013

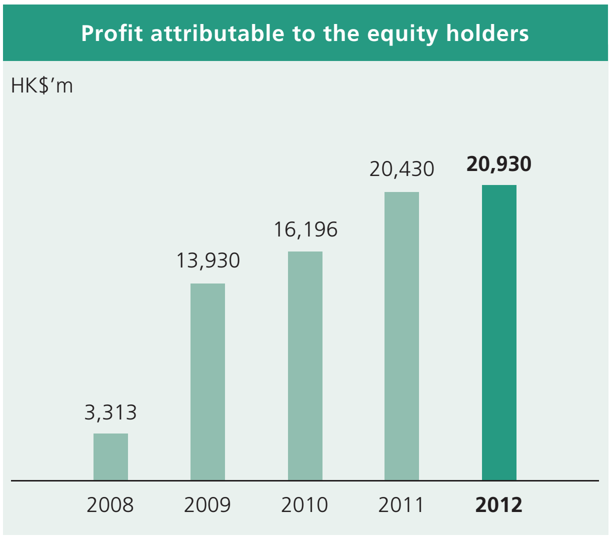
The outlook for the Hong Kong economy in 2013 remains challenging. It is expected that the local economy will continue to benefit from gradual economic recovery in the US and a pick-up in the Mainland, but uncertainties and challenges still exist, particularly in the external environment. The fiscal uncertainty in the US and the further evolvement of the European debt crisis could pose major threats to the global economy and hence external demand for Hong Kong. Domestically, abundant liquidity leading to overheating of the property market and further asset rallies could bring huge volatility in the financial market. At the same time, persistently low interest rates continue to exert pressure on banks' profit. Additional regulatory requirements, including the implementation of Basel III, may increase banks' operating costs.

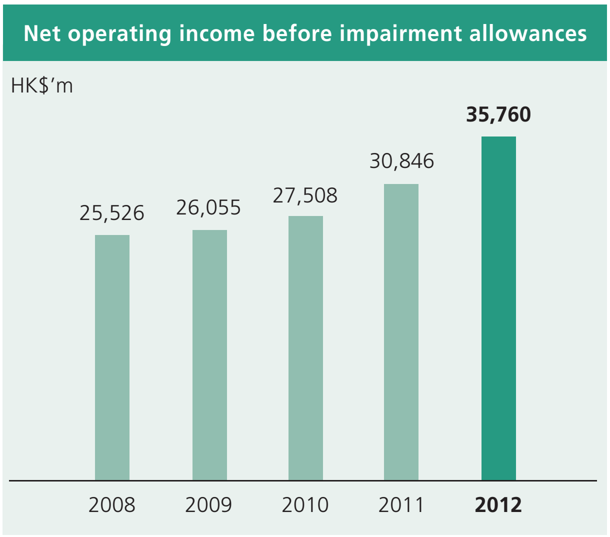
However, the continuing development of offshore RMB business in Hong Kong will provide new opportunities. New initiatives for the Qianhai Cooperation Zone and RQFII are expected to bring new customers and business opportunities to the banking sector in 2013.

MANAGEMENT'S DISCUSSION AND ANALYSIS

CONSOLIDATED FINANCIAL REVIEW

Financial Highlights





HK$'m	**2012**	2011
Net operating income before impairment allowances	**35,760**	30,846
Operating expenses	**(11,402)**	(7,862)
Operating profit before impairment allowances	**24,358**	22,984
Operating profit after impairment allowances	**23,499**	22,478
Profit before taxation	**25,521**	24,680
Profit attributable to the equity holders of the Company	**20,930**	20,430

Despite external uncertainties and sluggish demand, the Group achieved encouraging financial results in 2012. By capitalising on its core competencies and proactively managing its assets and liabilities, the Group responded swiftly to market changes and was able to capture new business opportunities. As a result, the Group recorded solid growth in core businesses and saw increased contribution from the offshore RMB businesses. At the same time, it maintained stringent risk management in the challenging environment. The financial position of the Group remains solid with key financial ratios at healthy levels.

The Group's net operating income before impairment allowances increased by HK$4,914 million or 15.9% to HK$35,760 million. Net interest income was the major driver, with growth attributable to loan growth with improved yield and better deployment of RMB funds. Net fee and commission income rose slightly. Other income increased, mainly driven by the mark-to-market gain and growth in income from the Group's insurance segment. Operating expenses rose by 45.0%, primarily due to the net recovery from the underlying collateral of the Lehman Brothers Minibonds in 2011. Operating profit before impairment allowances grew by 6.0%. Excluding the impact of the Lehman Brothers related products, it would have increased by 20.2%. Net charge of loan impairment allowances increased while the net gain on investment property revaluation fell year-on-year. As a result, profit attributable to the equity holders of the Company rose by 2.4% compared to 2011. Excluding the impact of Lehman Brothers-related products, profit attributable to the equity holders would have increased by 14.9%.

As compared to the first half of 2012, the Group's net operating income before impairment allowances declined by 3.1% in the second half. The decrease was mainly due to the lower net interest income and the decline in net fee and commission income. It was partially offset by growth in other income. The Group recorded a higher net charge of loan impairment allowances and a lower net gain on investment property revaluation in the second half of the year. Profit attributable to the equity holders decreased by HK$1,556 million or 13.8% on a half-on-half basis.

Factors Affecting the Group's Performance in 2012

The key positive factors that contributed to the Group's 2012 financial performance are outlined below:

- The Group's proactive asset and liability management achieved a ***healthy growth in both loans and deposits*** with ***effective control of deposit costs and improved loan pricing***.
- Fee and commission income on ***traditional banking businesses*** and ***funds distribution*** performed strongly with double-digit growth.
- The Group successfully captured business opportunities in the ***offshore RMB business***. The better deployment of RMB funds is one of the key factors contributing the rise in profit.
- The Group further improved its service capabilities and focused on ***operational efficiency***.

The Group's financial performance in 2012 was also subject to the following key negative factors:

- The exceptionally low market interest rates constrained enhancement of the Group's ***asset yield***. Intense market competition for deposits also led to higher ***funding costs***.
- The uncertain economic prospects resulting in ***sluggish demand and lower trade activities*** adversely affected the related fee income.

INCOME STATEMENT ANALYSIS

Net Interest Income and Margin

HK$'m, except percentages	**2012**	2011
Interest income	**35,413**	31,931
Interest expense	**(10,705)**	(9,952)
Net interest income	**24,708**	21,979
Average interest-earning assets	**1,542,565**	1,662,201
Net interest spread	**1.49%**	1.24%
Net interest margin#	**1.60%**	1.32%

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

The Group's net interest income increased by HK$2,729 million or 12.4% year-on-year, driven by widening net interest margin. Average interest-earning assets contracted by HK$119,636 million or 7.2%, mainly due to the drop in participating banks' RMB deposits with the clearing bank. Net interest margin was 1.60%, up 28 basis points compared to 2011, with net interest spread increasing by 25 basis points and contribution from net free funds rising by 3 basis points.

The growth in net interest margin was mainly attributable to improved return from the offshore RMB business and eased dilution by the Group's RMB clearing bank business. The return from the offshore RMB business improved with the increased deployment of RMB funds in loans and advances and bonds. In previous periods, the Group's RMB clearing bank business had a lower average spread than other businesses and dragged on overall net interest margin. In line with new developments in the offshore RMB market, participating banks reduced their RMB deposits with the clearing bank. As a result, the diluting effect of the Group's RMB clearing bank business on net interest margin was insignificant in 2012. Meanwhile, the pricing of corporate and residential mortgage loans improved, but the positive impact was partially offset by rising deposit costs amid keen market competition and increase in lower yielding investments in short-term debt securities.

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

ASSETS	Year ended 31 December 2012 Average balance HK$'m	Year ended 31 December 2012 Average yield %	Year ended 31 December 2011 Average balance HK$'m	Year ended 31 December 2011 Average yield %
Balances and placements with banks and other financial institutions	**335,842**	**2.43%**	571,705	1.48%
Debt securities investments	**471,662**	**2.07%**	420,154	2.35%
Loans and advances to customers	**720,488**	**2.38%**	654,802	2.04%
Other interest-earning assets	**14,573**	**1.71%**	15,540	1.50%
Total interest-earning assets	**1,542,565**	**2.29%**	1,662,201	1.92%
Non interest-earning assets	**191,823**	**–**	161,788	–
Total assets	**1,734,388**	**2.04%**	1,823,989	1.75%

LIABILITIES	Average balance HK$'m	Average rate %	Average balance HK$'m	Average rate %
Deposits and balances from banks and other financial institutions	**143,219**	**0.68%**	378,841	0.77%
Current, savings and fixed deposits	**1,112,820**	**0.81%**	1,023,278	0.61%
Subordinated liabilities	**28,678**	**1.09%**	27,800	2.02%
Other interest-bearing liabilities	**44,012**	**0.92%**	39,403	0.50%
Total interest-bearing liabilities	**1,328,729**	**0.80%**	1,469,322	0.68%
Non interest-bearing deposits	**83,588**	**–**	69,877	–
Shareholders' funds* and non interest-bearing liabilities	**322,071**	**–**	284,790	–
Total liabilities	**1,734,388**	**0.62%**	1,823,989	0.55%

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

Second Half Performance

Compared to the first half of the year, net interest income decreased by HK$530 million, or 4.2%, to HK$12,089 million. Average interest-earning assets dropped slightly by 0.3%. Net interest margin was 1.56%, down 8 basis points half-on-half. Average asset yields of debt securities and interbank placements were lower with the decline in market interest rates. Rising RMB customer deposit costs amid keen market competition, coupled with increase in lower yielding investments in short-term debt securities also put pressure on net interest margin. Meanwhile, RMB bonds and loans continued to increase while the pricing of corporate and residential mortgage loans also improved in the second half.

Net Fee and Commission Income

HK$'m	2012	2011
Credit cards business	**3,307**	2,887
Securities brokerage	**2,114**	2,782
Loan commissions	**1,628**	1,160
Insurance	**965**	1,097
Bills commissions	**736**	854
Payment services	**667**	637
Funds distribution	**540**	337
Trust and custody services	**360**	379
Safe deposit box	**228**	211
Currency exchange	**156**	156
Others	**409**	358
Fee and commission income	**11,110**	10,858
Fee and commission expenses	**(3,204)**	(3,025)
Net fee and commission income	**7,906**	7,833

Net fee and commission income increased by HK$73 million, or 0.9%, to HK$7,906 million. Fee and commission income from loans, credit cards and funds distribution grew strongly. The increase, however, was mostly offset by the decline of commission income from securities brokerage, insurance and bills, reflecting the subdued investors' sentiment and trade activities. Loan commissions surged by 40.3%, driven by higher commissions from corporate loans. Fee income from the credit card business grew by 14.5%, driven by the increase of 10.9% and 14.6% respectively in cardholder spending and merchant acquiring volume. Commission from funds distribution rose substantially by 60.2% with the Group's strong performance in the distribution of RQFII funds and its continuous efforts in developing products to meet customers' needs. Meanwhile, fee income from payment services also registered growth.

Second Half Performance
Compared to the first half of 2012, net fee and commission income decreased by HK$298 million or 7.3% in the second half. Fee and commission income from the credit card business and funds distribution saw continued growth momentum from the first half. However, loan commissions dropped from a high level in the first half and insurance commission income decreased.

Net Trading Gain

HK$'m	2012	2011
Foreign exchange and foreign exchange products	**1,988**	1,430
Interest rate instruments and items under fair value hedge	**900**	12
Equity instruments	**120**	82
Commodities	**121**	186
Net trading gain	**3,129**	1,710

Net trading gain was HK$3,129 million, up HK$1,419 million or 83.0% year-on-year. Reduction in foreign exchange loss on foreign exchange swap contracts* was the major driver for the increase in net trading gain from foreign exchange and foreign exchange products. This was partly offset by the lower gain from currency exchange activities. The growth in net trading gain from interest rate instruments and items under fair value hedge was mainly attributable to the mark-to-market changes on certain interest rate instruments, caused by market interest rate movements. The growth in net trading gain from equity instruments was mainly attributable to the gain from equity-linked products that were well received by customers. The decrease in trading gain from commodities was due to the decline in bullion transactions.

Second Half Performance

Compared to the first half of 2012, net trading gain increased by HK$313 million or 22.2%. This was mainly due to the mark-to-market changes of foreign exchange swap contracts and certain interest rate instruments.

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

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

HK$'m	2012	2011
Banking business of the Group	42	(1)
BOC Life	705	(339)
Net gain/(loss) on financial instruments designated at fair value through profit or loss	747	(340)

The Group recorded a net gain of HK$747 million on financial instruments designated at FVTPL this year, compared to a net loss recorded in the previous year. The net gain in 2012 was mainly attributable to the mark-to-market changes of debt securities and the gain from equity investments of BOC Life, compared to the net loss in 2011 amid the weak financial market. The changes in market value of its securities portfolio were substantially offset by the corresponding changes in policy reserves, as reflected in the changes in net insurance benefits and claims which were attributable to the movement of market interest rates.

Second Half Performance

Net gain on financial instruments designated at FVTPL in the second half of the year was HK$561 million, up HK$375 million half-on-half. The gain recorded in the second half of the year was mainly attributable to the improved performance of BOC Life's investment portfolio amid the recovering financial market.

Operating Expenses

HK$'m	2012	2011
Staff costs	6,406	6,038
Premises and equipment expenses (excluding depreciation)	1,456	1,390
Depreciation on owned fixed assets	1,493	1,277
Other operating expenses	2,143	1,954
Core operating expenses	11,498	10,659
Impact of Lehman Brothers-related products*	(96)	(2,797)
Total operating expenses	11,402	7,862

	At 31 December 2012	At 31 December 2011
Staff headcount measured in full-time equivalents	14,638	14,475

* Refer Note 12 to the Financial Statements for details.

Total operating expenses increased by HK$3,540 million, or 45.0%, to HK$11,402 million, as there was a larger net recovery from the underlying collateral of the Lehman Brothers Minibonds in 2011. Core operating expenses rose by HK$839 million, or 7.9%. The Group focused on operational efficiency and maintained disciplined cost control while continuing to invest in new business platforms and Mainland operations to support long-term business growth.

Staff costs increased by 6.1%, reflecting higher salaries as a result of annual salary increment and increase in headcount in the Mainland business.

Premises and equipment expenses rose by 4.7% with higher rental for branches in Hong Kong and the Mainland.

Depreciation on owned fixed assets rose by 16.9% due to larger depreciation charge on premises following 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 9.7% mainly due to higher expenses to support business growth, such as marketing expenses, and business taxes of NCB (China).

Compared to the end of 2011, headcount measured in full-time equivalents rose by 163, mostly in the Mainland business as a result of the expansion of NCB (China).

Second Half Performance
Compared to the first half of 2012, operating expenses rose by HK$620 million. The increase was due to higher staff costs, marketing, rental and depreciation expenses, as well as business taxes of the Mainland business in the second half of the year.

Net Charge of Loan Impairment Allowances

HK$'m	**2012**	2011
Net charge of allowances before recoveries		
– individual assessment	**(512)**	(12)
– collective assessment	**(606)**	(720)
Recoveries	**264**	353
Net charge of loan impairment allowances	**(854)**	(379)

The Group maintained stringent risk management in a volatile economic environment. Overall loan quality remained sound. The net charge of loan impairment allowances amounted to HK$854 million, up HK$475 million from previous year, owing to the increase in the net charge of individually assessed impairment allowances.

Net charge of individually assessed impairment allowances increased to HK$512 million, mainly caused by the downgrade of a few corporate loans.

Net charge of collectively assessed impairment allowances decreased year-on-year. The higher net charge in 2011 was largely due to the stronger loan growth.

Recoveries amounted to HK$264 million, down HK$89 million or 25.2% from 2011.

Second Half Performance
A net charge of loan impairment allowances of HK$767 million was recorded in the second half of 2012, up from a net charge of HK$87 million in the first half. The increase was mainly due to a higher net charge of individual assessed impairment allowances.

Total loan impairment allowances as a percentage of gross advances to customers

	At 31 December 2012	At 31 December 2011
Loan impairment allowances		
– individual assessment	**0.10%**	0.03%
– collective assessment	**0.38%**	0.37%
Total loan impairment allowances	**0.48%**	0.40%

BALANCE SHEET ANALYSIS

Asset Deployment

	At 31 December 2012		At 31 December 2011	
HK$'m, except percentages	Amount	% of total	Amount	% of total
Cash and balances with banks and other financial institutions	**198,748**	**10.9%**	278,795	16.0%
Placements with banks and other financial institutions maturing between one and twelve months	**66,025**	**3.6%**	107,910	6.2%
Hong Kong SAR Government certificates of indebtedness	**82,930**	**4.5%**	65,890	3.8%
Securities investments[1]	**531,696**	**29.0%**	425,600	24.5%
Advances and other accounts	**819,739**	**44.8%**	755,229	43.5%
Fixed assets and investment properties	**63,107**	**3.4%**	52,091	3.0%
Other assets[2]	**68,518**	**3.8%**	52,995	3.0%
Total assets	**1,830,763**	**100.0%**	1,738,510	100.0%

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

As at 31 December 2012, the Group's total assets amounted to HK$1,830,763 million, increasing by HK$92,253 million or 5.3% from the end of 2011. In 2012, the Group continued to strengthen its asset and liability management with the aim to improve profitability and enhance its risk profile. It maintained a balanced strategy in business growth. Conscious efforts were made to enhance loan pricing, control funding costs and optimise asset allocation.

Key changes in the Group's total assets include:

- Cash and balances with banks and other financial institutions decreased by 28.7%, mainly due to the decrease in RMB funds placed with the People's Bank of China ("PBOC") by BOCHK's clearing business as participating banks' RMB deposits with the clearing bank continued to decline.

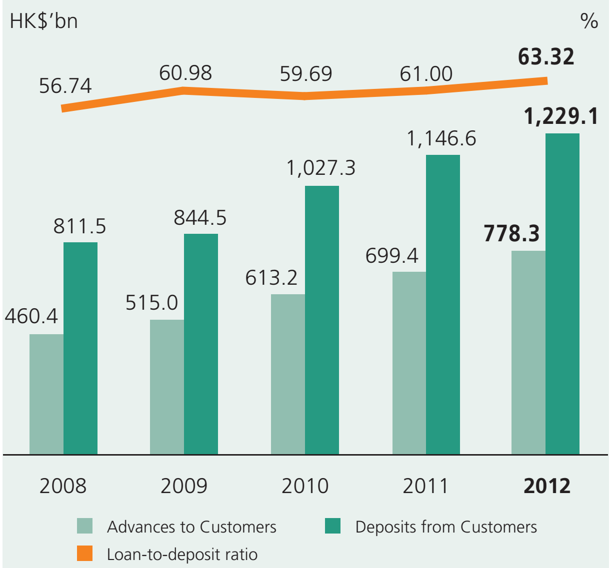
- Placements with banks and other financial institutions maturing between one and twelve months dropped by 38.8% as the Group redeployed its funds for advances to customers and securities investments.

- Securities investments increased by 24.9% with increase mainly in government-related bonds, high-quality financial institutions and corporate bonds.

- Advances and other accounts rose by 8.5%, which was mainly attributable to the growth in advances to customers by 11.3%.

- Other assets grew strongly by 29.3%, which was mainly led by the increase in reinsurance assets, derivative financial instruments as well as accounts receivable and prepayments.

Advances to customers and deposits from customers[1]



1. Deposits from customers include structured deposits
2. As at 31 December

Advances to Customers

HK$'m, except percentages	At 31 December 2012 Amount	At 31 December 2012 % of total	At 31 December 2011 Amount	At 31 December 2011 % of total
Loans for use in Hong Kong	**480,753**	**61.8%**	444,540	63.6%
Industrial, commercial and financial	**252,877**	**32.5%**	237,557	34.0%
Individuals	**227,876**	**29.3%**	206,983	29.6%
Trade finance	**67,137**	**8.6%**	59,508	8.5%
Loans for use outside Hong Kong	**230,374**	**29.6%**	195,331	27.9%
Total advances to customers	**778,264**	**100.0%**	699,379	100.0%

Despite the global economic slowdown, the Group continued to capitalise on its strong customer base and financial position to capture loan growth opportunities. At the same time, it adhered to stringent risk control and customer selection to achieve quality and sustainable growth. Advances to customers grew by HK$78,885 million or 11.3% to HK$778,264 million in 2012.

Loans for use in Hong Kong grew by HK$36,213 million or 8.1%.

- Lending to the industrial, commercial and financial sectors increased by HK$15,320 million, or 6.4%, to HK$252,877 million, covering a wide range of industries. Lending to the information technology, manufacturing and property investment sectors grew by 33.1%, 25.4% and 5.6% respectively.

- Lending to individuals increased by HK$20,893 million, or 10.1%. Residential mortgage loans (excluding those under the Government-sponsored Home Ownership Scheme) grew by 9.9% as the Group captured the growth opportunities arising from the revival of the local residential property market. Credit card advances increased by 19.5%. Other loans to individuals rose by 20.1%.

Trade finance rose by HK$7,629 million, or 12.8%. Meanwhile, loans for use outside Hong Kong grew by HK$35,043 million or 17.9%.

Second Half Performance

Loan growth slowed down in the second half of the year against the backdrop of slowing economic growth. The Group's advances to customers increased by HK$31,512 million or 4.2%, mainly driven by the growth in lending to individuals and loans for use outside Hong Kong.

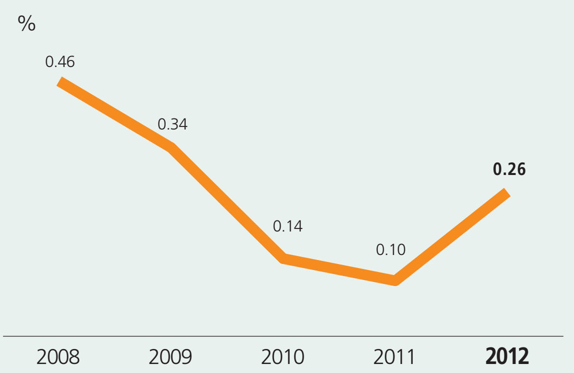
Loan Quality

HK$'m, except percentages	**At 31 December 2012**	At 31 December 2011
Advances to customers	**778,264**	699,379
Classified or impaired loan ratio	**0.26%**	0.10%
Impairment allowances	**3,705**	2,830
Regulatory reserve for general banking risks	**7,754**	6,967
Total allowances and regulatory reserve	**11,459**	9,797
Total allowances as a percentage of advances to customers	**0.48%**	0.40%
Impairment allowances[1] on classified or impaired loan ratio	**37.44%**	39.86%
Residential mortgage loans[2] – delinquency and rescheduled loan ratio[3]	**0.02%**	0.01%
Card advances – delinquency ratio[3]	**0.17%**	0.16%

	2012	2011
Card advances – charge-off ratio[4]	**1.24%**	1.07%

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 year to average card receivables during the year.

Classified or impaired loan ratio



* as at 31 December

The Group's overall loan quality remained sound. The classified or impaired loan ratio was at 0.26%. Classified or impaired loans rose by HK$1,344 million to HK$2,054 million, mainly due to the downgrade of a few corporate loans. Formation of new classified loans in 2012 represented approximately 0.26% of total loans outstanding.

Total impairment allowances, including both individual assessment and collective assessment, amounted to HK$3,705 million. Total impairment allowances on classified or impaired loans as a percentage of total classified or impaired loans was at 37.44%.

The credit quality of the Group's residential mortgage loans remained sound with the combined delinquency and rescheduled loan ratio standing at 0.02% at the end of 2012. As compared to 2011, the charge-off ratio of card advances increased by 0.17 percentage point to 1.24%, better than the market average.

Deposits from Customers*

HK$'m, except percentages	At 31 December 2012 Amount	At 31 December 2012 % of total	At 31 December 2011 Amount	At 31 December 2011 % of total
Demand deposits and current accounts	**97,295**	**7.9%**	77,440	6.7%
Savings deposits	**603,565**	**49.1%**	504,868	44.0%
Time, call and notice deposits	**525,430**	**42.8%**	563,643	49.2%
	1,226,290	**99.8%**	1,145,951	99.9%
Structured deposits	**2,841**	**0.2%**	639	0.1%
Deposits from customers	**1,229,131**	**100.0%**	1,146,590	100.0%

* Including structured deposits.

The Group maintained a proactive deposit strategy to support business growth with cautious control of funding costs. In spite of intense competition, the Group enlarged its deposit base by HK$82,541 million, or 7.2% to HK$1,229,131 million. Demand deposits and current accounts grew by 25.6% while savings deposits increased by 19.5%. Time, call and notice deposits fell by 6.8%. The Group's loan-to-deposit ratio was 63.32% at the end of 2012, up 2.32 percentage points from the end of last year.

Second Half Performance

Total deposits from customers increased by HK$43,850 million or 3.7% in the second half of 2012. Demand deposits and current accounts increased strongly by 31.5% while savings deposits went up by 15.0%. Time, call and notice deposits declined by 10.1%.

Capital and Reserves Attributable to the Equity Holders of the Company

HK$'m	At 31 December 2012	At 31 December 2011
Share capital	**52,864**	52,864
Premises revaluation reserve	**31,259**	23,150
Reserve for fair value changes of available-for-sale securities	**5,510**	1,787
Regulatory reserve	**7,754**	6,967
Translation reserve	**771**	674
Retained earnings	**52,811**	44,323
Reserves	**98,105**	76,901
Capital and reserves attributable to the Equity Holders of the Company	**150,969**	129,765

Capital and reserves attributable to the equity holders increased by HK$21,204 million, or 16.3% to HK$150,969 million at 31 December 2012. Retained earnings increased by 19.2%, reflecting the 2012 profit after the appropriation of dividends. Premises revaluation reserve increased by 35.0%, which was attributable to the increase in property prices in 2012. Regulatory reserve rose by 11.3% due to loan growth. Reserve for fair value changes of available-for-sale securities increased by 208.3%, mainly due to the changes in market interest rates.

Capital and Liquidity Ratio

HK$'m, except percentages	**At 31 December 2012**	At 31 December 2011
Core capital after deductions	**89,096**	84,600
Supplementary capital after deductions	**32,452**	29,654
Total capital base after deductions	**121,548**	114,254
Total risk-weighted assets	**723,699**	676,024
Capital adequacy ratios (consolidated basis)		
Core capital ratio	**12.31%**	12.51%
Capital adequacy ratio	**16.80%**	16.90%

	2012	2011
Average liquidity ratio	**41.20%**	36.17%

Consolidated capital adequacy at 31 December 2012 was 16.80%, down 0.10 percentage point from that at the end of 2011. Total capital base expanded by 6.4% to HK$121,548 million, mainly due to the increase in retained earnings. Total risk-weighted assets increased by 7.1% to HK$723,699 million. The increase was mainly due to the growth of credit risk-weighted assets in light of the growth in loans and debt securities investments in 2012. The increase was counterbalanced by the effect of no additional risk-weighted amount required for the capital floor adjustment as the Group's capital charges for the year exceeded the required capital floor amount*.

For information on the components of total capital base and type of capital instruments used, please refer to Note 4.5 and 41 to the Financial Statements in this Annual Report.

The average liquidity ratio in 2012 remained strong at 41.20%.

* The HKMA requires that all reporting institutions using the IRB approach (whether foundation or advanced) for capital adequacy purposes are subject to a capital floor for the first three years of the adoption of the IRB approach. The use of the capital floor is to prevent a sudden fall in capital charges solely as a result of the changes in how the risk-weighted amount for credit risk is measured. The capital floor is derived by applying an adjustment factor to the capital charge calculated under the STC approach where the adjustment factors are 90%/80%/70% for the respective 1st/2nd/3rd year of the implementation of IRB approach. As at 31 December 2012 and in its second year of the implementation of FIRB approach, the Group's capital charges exceeded the capital floor amount as required by the HKMA and therefore no additional risk-weighted amount was required for the year.

BUSINESS REVIEW

2012 Business Highlights

Personal Banking

- Maintained leading position in residential mortgages with a larger market share
- Commission income from funds distribution surged by 60.2% through widened and customer-oriented product offerings and enhanced sales model
- Introduced three new funds through BOCHK Asset Management Limited
- Consolidated Wealth Management platform and launched Private Banking service to high-net-worth customers
- Achieved strong growth in credit card business with credit card advances rising by 19.5%
- Continued to invest in servicing capabilities via branches, electronic means and cross-border connection to elevate customer experience
- Received "Best Internet Banking" and "Best Mobile Telephone Banking" awards under the Capital Weekly Service Awards 2012

Corporate Banking

- Remained the top mandated arranger in the Hong Kong-Macau syndicated loan market
- Recorded a healthy growth of 11.6% in corporate loans with improvement in pricing
- Received "SME's Best Partner Award" for the fifth consecutive year
- Further expanded the range of cash management services and launched the new corporate internet banking platform, BOCNET HK
- Expanded the client base for custody services with BOCHK being named the "Best Asian Bank for Cross-Border Custody" in the AsianInvestor Service Provider Awards 2012

Treasury

- Proactively adjusted portfolio mix to enhance return while staying attuned to risk. Increased investments in government-related bonds, high-quality financial institutions and corporate bonds as well as RMB-denominated bonds
- Extended the overseas RMB banknotes business and established business relationships with banks, financial institutions and non-bank institutions in different countries and regions

Insurance

- Maintained leading position in RMB insurance market in Hong Kong
- Improved product features and varieties to meet changing customer needs
- Granted approval to invest directly in the Mainland's interbank bond market

Mainland Business

- Focused on asset and liability management to improve asset yields and deposit mix
- Expanded branch network to a total of 36 at end-2012 with the addition of nine new sub-branches
- "Channel Sharing" with BOC garnered satisfactory business growth and became a vital service channel
- SME business platform achieved success with strong business momentum

RMB Business in Hong Kong

- Maintained leading position in offshore RMB banking businesses, including deposit taking, trade settlement, bond underwriting, credit card and insurance
- Arranged the first 100% RMB-denominated syndicated loan
- Launched RMB services to non-Hong Kong residents from August 2012
- Remained the largest service provider for RQFII authorised funds in the market
- Launched three new offshore RMB bond sub-indices
- Extended operating hours of the RMB RTGS system

Others

- BOCHK Asset Management Limited established exclusive partnerships for the provision of investment services with the World Bank in Hong Kong, a prestigious private bank in Germany and a reputable asset management company in Taiwan
- BOCHK Asset Management Limited was granted five prestigious "2012 Best of the Best Awards" by Asia Asset Management

MANAGEMENT'S DISCUSSION AND ANALYSIS

Business Segment Performance

Profit before Taxation by Business Segments

	2012		2011	
HK$'m, except percentages	**Amount**	**% of total**	Amount	% of total
Personal Banking	**5,513**	**21.6%**	4,896	19.8%
Corporate Banking	**9,725**	**38.1%**	8,636	35.0%
Treasury	**8,382**	**32.8%**	6,515	26.4%
Insurance	**609**	**2.4%**	33	0.1%
Others[1]	**1,292**	**5.1%**	4,600	18.7%
Total profit before taxation	**25,521**	**100.0%**	24,680	100.0%

1. Profit before taxation of Others in 2012 and 2011 included the net recovery from the underlying collateral of the Lehman Brothers Minibonds.
2. For additional segmental information, see Note 49 to the Financial Statements.

PERSONAL BANKING

Financial Results

Personal Banking recorded an increase of HK$617 million, or 12.6%, in profit before taxation.

Net interest income increased notably by 15.5%. This was made possible by the improvement in deposit spread coupled with the growth in average loans and deposits. Personal loans and customer deposits grew by 10.7% and 10.9% respectively from last year end.

Net fee and commission income decreased by 2.4%, mainly due to the lower commission income from securities brokerage as investors' sentiment weakened. Nevertheless, there was strong growth in fee income from funds distribution and credit cards. Net trading gain dropped by 4.1%, due to lower foreign exchange related income.

Business operation

The Group's Personal Banking business continued to flourish in 2012. Growth was satisfactory in both the deposit and lending businesses. It remained the market leader in new mortgage loans and gained a larger market share in its loan outstanding. The funds and bond distribution businesses performed strongly. In addition to the Group investing in service enhancement and consolidating its wealth management business, the new Private Banking service was launched to provide unique and tailor-made services targeted at high-net-worth customers. Distribution channels were further optimised to enhance customer experience.

Residential mortgages – gaining a larger market share

With the widest range of products and dedicated services across all channels, the Group was the bank of choice and the market leader in new mortgage loans during the year. The "1 Day Approval Mortgage Services" was the first-of-its-kind in the market, allowing eligible home buyers to obtain formal approval of their mortgage loan applications within one business day. RMB mortgage services to non-Hong Kong residents was also the first in the market. At the end of 2012, the balance of the Group's mortgage book grew by 9.9% compared with the end of last year.

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

In 2012, sentiment in the local stock market was adversely affected by the external environment. Nevertheless, the Group continued to expand its stock brokerage services to reinforce its strong position in the personal securities business. In addition to maintaining stable trading environments through various channels, including internet, mobile and phone banking as well as at branches, new services continued to be rolled out during the year to strengthen the Group's service range. IPO share subscriptions and IPO financing through mobile banking were launched to give convenience to customers. The "Personalised Securities Services" was introduced to provide high-end customers with more flexible and convenient trading services. The Group also launched the new "Securities Club" which provides services suited to the needs of customers of various segments.

With regards to the funds distribution business, the Group rolled out new products to both high-end and mass retail customers. A private fund, the "BOCHK Asian Dynamic Income Fund", and two retail funds, the "BOCHK-World Bank Emerging Markets Bond Fund" and the "BOCHK All Weather Global Opportunities Fund", were launched. During the year, the Group distributed 14 RQFII funds, making it the largest distributor of RQFII funds in Hong Kong. As a result, commission income from funds distribution surged by 60.2% year-on-year. The Group also actively engaged in the bond distribution business. It underwrote a significant number of RMB bond issuances in the market with a substantial increase in turnover compared with 2011. At the same time, considerable effort was put into diversifying the business by engaging in USD and HKD bond issuance, which was well received by customers. The Group's private placement services for bonds in the secondary market were launched in January 2012. Meanwhile, the Group led the iBond market in terms of over-the-counter turnover. As a result, the Group achieved considerable improvement in commission from bond distribution.

In the Bancassurance business, the Group strengthened its position as a prominent life insurance provider and maintained its lead in the RMB insurance market. It continued to roll out different new products to meet customers' demand at different life stages and aimed to be the life partner of all customers. The "IncomeGrowth Annuity Insurance Plan" was introduced to offer life protection with guaranteed annuity payments. Professional training programmes were conducted throughout the year to develop the financial planning team's sales capabilities.

Credit card business – double-digit volume growth

The Group's credit card business sustained its growth momentum in 2012. It maintained its leadership in the China UnionPay merchant acquiring business and card issuing business. Dual currency credit cards were offered to Hong Kong and non-Hong Kong residents. The Group continued to exploit its competitive edge by launching appealing merchant offer programmes to customers through its comprehensive merchant network in Hong Kong, Macau and the Mainland. Credit card advances rose by 19.5%. Cardholder spending and merchant acquiring volumes grew by 10.9% and 14.6% respectively.

Wealth Management service – one-stop wealth management solutions

In 2012, the Group consolidated its Wealth Management service platform to strengthen its brand awareness and position in the market. It strived to foster long-term relationships with Wealth Management customers by offering more diverse services and customised solutions to meet their different needs. In addition, the Group launched Private Banking services to cater to the more sophisticated needs of high-net-worth customers and fulfil increasing demand for premium services in the Mainland and the rest of Asia. The Group also strengthened cooperation with BOC branches to provide banking services with extra convenience to customers of the two banks. The linkage of BOCHK's customer service hotline with that of BOC was completed, providing cross-border enquiry services between the two banks. The Group also launched "Time Housekeeper" service, allowing Wealth Management customers of BOCHK and BOC's branches in Guangdong province to perform designated services in selected branches in either region by advanced appointment. At the end of 2012, the total number of Wealth Management customers and the value of their assets under management increased by 6.7% and 18.0%, respectively, from end-2011.

Distribution channels – a new concept branch was grandly opened

The Group continued to optimise its distribution channels to meet the needs of both local and cross-border customers. During the year, a brand new concept branch, in a unique and contemporary design, was opened in Causeway Bay, to enhance customer service experience. At the end of 2012, the Group's service network in Hong Kong comprised 269 branches, including 140 wealth management centres.

The Group further invested in automated banking channels. In April, it launched Hong Kong's first chip-based ATM card with enhanced security and new banking service functions. The features of the Group's e-Banking platform were expanded, including the use of a new security device for two-factor authentication.

In recognition of its well-received electronic platform and outstanding services, the Group was honoured with the "Best Internet Banking" award for the fourth consecutive year and the "Best Mobile Telephone Banking" award for the second consecutive year under the Capital Weekly Service Awards 2012. The Group also received the "2012 APCCAL Recognition Award – HKCCA Awards Best Contact Centre in Sustainability" by Asia Pacific Contact Centre Association Leaders ("APCCAL") and 11 other awards by the Hong Kong Call Centre Association ("HKCCA").

CORPORATE BANKING

Financial Results

Corporate Banking recorded a growth of HK$1,089 million, or 12.6%, 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 14.0%, mainly driven by the growth of loans and deposits. Corporate loans and customer deposits grew by 11.6% and 3.3% respectively.

Net fee and commission income increased by 13.4%, largely led by the growth in loan commissions and trust services, which was partly set off by the decline of bills commissions. Net trading gain rose by 22.1%, mainly attributable to higher income from foreign exchange services.

Business operation

Despite sluggish demand from corporates, the Group's Corporate Banking business maintained its growth momentum in 2012. It strived to provide "Total Solutions", with a full range of financial services, including innovative trade-related products and "Integrated Branches for Commercial Business", to better serve customers' needs. As a result, corporate loans grew satisfactorily with improvement in loan pricing. The Group also made good progress in its custody and cash management businesses. It was the largest custody service provider for RQFII authorised funds in the market. The service range of the cash management business was significantly expanded and the new corporate internet banking platform, BOCNET HK, was successfully launched.

Corporate lending business – 11.6% growth of corporate loans

The Group continued to focus on providing "Total Solutions" for core customers, and tailor-made services to large corporates and public sector entities. The Group also worked closely with BOC through the "Global Relationship Manager Programme" to provide comprehensive cross-border services to its customers. It strengthened customer relationships by enhancing expertise in industry management with better customer segmentation. At the end of 2012, the Group's balance of corporate loans grew by 11.6% from the end of 2011 with improvement in loan pricing. In 2012, the Group successfully arranged the first 100% RMB-denominated syndicated loan in Hong Kong and it remained the top mandated arranger in the Hong Kong-Macau syndicated loan market.

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

The Group enhanced its services for SME customers by offering total solutions and participating actively in the new "SME Financing Guarantee Scheme" supported by the HKSAR government. It optimised the business model of "Integrated Branches for Commercial Business" by establishing exclusive counters in selected branches and launching the "Business Integrated Account" to provide one-stop financial solutions to SME companies and their proprietors, partners and shareholders. In recognition of its long-standing support for SMEs in Hong Kong, the Group received for the fifth consecutive year the "SME's Best Partner Award" presented by the Hong Kong General Chamber of Small and Medium Business Limited.

Trade finance – launched innovative products

The Group further enhanced its competitiveness in the trade finance business and led the market in product innovation. New products and services launched this year included "RMB Offshore Export Finance" and "Supply-chain Finance". In recognition of its contribution to the shipping industry by offering the innovative "Multi-currency Shipping Finance (RMB and USD)", the Group was granted the "Innovation Award – Business Innovation" by Lloyd's List Global Awards 2012. The Lloyd's List is a leading daily newspaper in the global maritime industry. The provision of this finance product has marked a number of milestones for the Group in the industry, including the first export shipping contract settled in RMB and issuance of the first cross-border RMB Refund Guarantee. At the end of 2012, the Group's balance of trade finance grew by 12.8% from the end of 2011.

Cash Management service – expanded service range

The Group made solid progress in developing its cash management business. BOCNET HK, a new corporate internet banking platform targeting medium to large corporates, was launched to meet cash management needs as well as provide comprehensive e-banking services. "Business Integrated Account" was introduced during the year to provide better banking services to its corporate customers. The intra-day cash pooling service was launched to facilitate the development of internal cash pools by corporate customers for better internal cash flow management. In addition, the Group introduced "SWIFT for Corporate Service" to allow corporate customers to give instructions and communicate with the bank via the SWIFT network.

Custody service – further expansion of client base

The Group's custody business continued to flourish in 2012. It successfully secured mandates from a number of RQFII fund products during the year and was the largest service provider for RQFII authorised funds in the market. It continued to expand its institutional client base and secured mandates to provide global custody services to various Qualified Domestic Institutional Investors. In recognition of its outstanding cross-border custody capabilities and services, BOCHK won the "Best Asian Bank for Cross-Border Custody" in the AsianInvestor Service Provider Awards 2012. At the end of 2012, excluding the RMB fiduciary account for participating banks, total assets under the Group's custody were valued at HK$619 billion.

Risk management – proactive measures to safeguard asset quality

The Group continued to carry out rigorous risk management and credit control to safeguard asset quality in a volatile economic environment. Through frequent and comprehensive market and industry analysis, the Group has put in place prudent credit standards for corporate lending under the principle of "Know Your Customers". Furthermore, rigorous post-lending monitoring measures are taken to track early signs of loan deterioration and formulate timely and effective precautionary courses of action.

MAINLAND BUSINESS

Financial performance – encouraging growth

In 2012, the Group's Mainland business maintained encouraging growth in a challenging banking environment. Customer deposits and loans registered satisfactory growth of 12.8% and 21.2% respectively from the end of last year. Loan quality remained sound. During the year, the PBOC cut benchmark deposit and loan interest rates and adjusted the interest rate floating range. Both of these posed pressure on interest margin of the Mainland business. Nevertheless, the Group swiftly adjusted its asset and liability structure to improve asset yields. As a result, net operating income increased by 17.9%.

Product and service offerings – enhanced product and service capability

In response to the increasing demand for wealth management services, the Group successfully introduced a new series of "Yi Da" wealth management products. The return of these products is linked to interest rates, exchanges rates, gold and commodity prices. The first series of off-balance sheet wealth management products, "Yixiang", was also launched in the second half of the year. All wealth management products can be accessed through the e-Banking platform. NCB (China) has been granted regulatory approval for the issuance of credit cards in the Mainland. The SME business platform was instrumental to the completion of the "SME Business Win" product series, leading to strong growth in both loans to and deposits from SMEs.

Distribution channels – expanded branch network and channel sharing with BOC

The Group continued to deepen business collaboration with BOC. The "Channel Sharing" model, which allows NCB (China)'s debit card holders to access services through BOC's branches and ATMs, has been effective in serving its purpose. The model not only boosted deposit growth but also generated more retail banking business, becoming one of the most vital service channels for card holders. Meanwhile, the enhancement of the Group's e-Banking platforms proved to be successful as the number of new accounts and transaction volume increased significantly. During the year, there was an addition of nine new sub-branches, including eight NCB (China) sub-branches and one sub-Branch of Chiyu Banking Corporation Limited. The Group's total number of branches and sub-branches in the Mainland increased to 36 by the end of 2012.

MANAGEMENT'S DISCUSSION AND ANALYSIS

TREASURY

Financial Results

Treasury recorded a strong year-on-year increase of 28.7% in profit before taxation.

Net interest income increased by 15.4%. This was mainly driven by an increase in the balance of debt securities investments coupled with the improved yield on interbank placements.

Net trading gain was up 158.7%. The increase was mainly caused by the lower foreign exchange loss on foreign exchange swap contracts and the improved mark-to-market changes of certain interest rate instruments.

Business Operation

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

The Group continued to take a proactive approach in managing its banking book investments. It closely monitored market changes and acted swiftly to adjust its investment portfolio to enhance return while remaining vigilant of risks. In 2012, the Group selectively increased its investments in government-related bonds, high-quality financial institutions and corporate bonds. Meanwhile, the Group also increased its holdings in RMB-denominated bonds.

Product innovation – responsive to customers' needs

The Group remained customer-centric and continued to develop innovative products to meet customers' needs. Various innovative products were introduced during the year and were well-received by customers. New product offerings bundled offshore RMB exchange rate-related and interest rate-related products with deposits, loans and trade finance, thus lowering customers' exchange rate risk and financing costs.

As part of its ongoing efforts to facilitate the development of the offshore RMB bond market, the Group launched three new offshore RMB bond sub-indices. The BOCHK Offshore RMB Chinese Sovereign Bond Index, the BOCHK Offshore RMB Investment Grade Bond Index and the BOCHK Offshore RMB 1 to 3 Years Central Government Bond Index serve as performance benchmarks for the offshore RMB bond market. Meanwhile, the Group remained an active participant in the offshore RMB bond underwriting business, which saw a significant increase in market turnover over 2011.

RMB-clearing bank service – service hours extended to offshore markets

The Group continued to provide strong support in clearing services. The operating hours of the RMB RTGS were extended to cover the working hours in other major financial centres, including those in Europe and the US. Meanwhile, the use of the RMB RTGS system has been extended to a number of overseas participating banks, including BOC's overseas branches across Europe and Asia. These moves not only facilitated the increasing use of RMB for cross-border settlement and payment, but also enhanced the RMB clearing efficiency and service capability of BOCHK.

Banknotes business – global network expansion

The Group continued to cooperate with BOC in extending its overseas RMB banknotes business. The Group has also successfully established banknotes business relationships with other banks, financial institutions as well as non-bank institutions in different countries and regions.

INSURANCE

Financial Results

The Group's Insurance segment registered a profit before taxation of HK$609 million in 2012 versus HK$33 million in 2011. The growth was mainly attributable to the improved mark-to-market changes of debt securities and gain from equity investments, compared to an investment loss recorded in 2011 amid the credit volatility in the financial market.

Net insurance premium income grew by 13.5%.

Net charge of impairment allowances on securities investments decreased significantly year-on-year due to the relatively stable environment of credit market in 2012.

Business Operation

Driving growth through product and service enhancement

The Group continued to widen the insurance product range and enhance product features. "IncomeGrowth Annuity Insurance Plan", a major new product providing life protection with guaranteed annuity payments, was launched and well received by customers. A series of training programmes were conducted to improve the sales team's integrated capabilities. BOC Life also carried out several promotional campaigns to promote its product offerings. The sales of unit-linked products registered a satisfactory growth.

Core system migration to improve long-term competitiveness

During the year, BOC Life successfully revamped a life insurance administration system which enhances the speed of service and sales support and hence the overall service quality. This platform is more compatible to the long-term business development of BOC Life.

RMB insurance products – a prominent provider

The Group's leading position in the RMB insurance market was further enhanced through optimisation of and innovation in RMB products. Popular RMB insurance products such as the "Target 5 Years Insurance Plan Series", "Multi-Plus Savings Insurance Plan" and "RMB Universal Life Insurance Plan" continued to attract substantial new business. To cater to customers' needs, the Group launched the RMB denominated "IncomeGrowth Annuity Insurance Plan". During the year, BOC Life was granted the approval to invest directly in the Mainland's interbank bond market, thus facilitating the expansion of RMB assets and the further development of its RMB insurance products. In recognition of its significant contribution to the RMB market, BOC Life has been granted the honour of the "Hong Kong Offshore RMB Centre – 1st RMB Business Outstanding Awards – The Outstanding Insurance Business" organised by Metro Finance and Metro Finance Digital, with Hong Kong Wen Wei Po as the co-organiser.

OTHERS

Asset management service – making solid progress

Following the successful launch of two private RMB bond funds in 2011, the Group introduced three new funds to both high-end and mass retail customers in 2012 through BOCHK Asset Management Limited ("BOCHK AM"), a wholly owned subsidiary of BOC Hong Kong (Holdings) Limited. These included a private fund and two retail funds which were well received by customers. During the year, BOCHK AM established exclusive partnerships for the provision of investment services with the World Bank in Hong Kong, a prestigious private bank in Germany and a reputable asset management company in Taiwan.

In recognition of its outstanding performance since its establishment in December 2010, BOCHK AM has been granted five prestigious "2012 Best of the Best Awards" by Asia Asset Management. The five awards include three Hong Kong and two regional honours. In addition, the RMB bond fund introduced in 2011, the "BOCHK RMB High Yield Bond Fund", was ranked by Bloomberg in 2012 as the best performing offshore RMB bond fund launched globally.

2013 Business Focuses

The year 2013 will bring both challenges and opportunities to the banking sector. The Group will stay highly aware and respond swiftly to market changes while maintaining stringent risk management and control.

To reinforce its strong franchise in the local market, the Group will focus on further enhancing customer experience to meet the needs of existing customers, while at the same time aim to increase penetration of targeted customers. Products and services of new business platforms will be further developed in conjunction with traditional core businesses to enhance the Group's service capabilities and competitive edge.

Leveraging opportunities from the further expansion of the offshore RMB business, the Group will continue to strengthen its core competencies and focus on its comparative advantages in the international arena. At the same time, it will work closely with BOC in cross-border services to enhance the overall service capabilities of the BOC Group.

In the Mainland, the Group will continue to build upon its business infrastructure by encouraging product customisation and innovation, and expanding service capabilities and product offerings to SMEs and personal customers. It will also leverage the competitive advantages of BOC to further extend its business network and increase cooperation.

REGULATORY DEVELOPMENT

Implementation of Basel III

Following the negative vetting of the Banking (Capital) (Amendment) Rules 2012 completed by the Legislative Council, the first phase of Basel III requirements came into operation on 1 January 2013. The rules detail revised capital requirements for all locally-incorporated authorised institutions in Hong Kong with amendments mainly relating to:

1. revisions to both the minimum capital ratio requirement (in terms of expanding the existing capital adequacy ratio into three ratios, namely, a Common Equity Tier 1 capital ratio, a Tier 1 capital ratio, and a Total capital ratio) and the definition of regulatory capital;

2. enhancements to the counterparty credit risk framework, including a revised capital framework for exposures to central counterparties; and

3. amendments on the capital treatment for certain trade financing activities and securities financing transactions.

The implementation of the Basel III Accord will enhance the resilience of the banking system in Hong Kong. The Group has assessed the relevant impact and is well prepared for the implementation of the new capital standards.

Implementation of LM-2 "Sound Systems and Controls for Liquidity Risk Management"

The Supervisory Policy Manual LM-2 "Sound Systems and Controls for Liquidity Risk Management" was issued by the HKMA in 2011. This module provides a detailed description of the system and control standards for the governance, risk management and disclosure of liquidity risk that authorised institutions are expected to have in place. In accordance with the requirements set forth in the module, the Group has embarked to refine the behaviour model and assumptions of existing cash flow analysis and stress test to enhance the Group's cash flow analysis under both normal and stressed conditions. In addition, the Group has a policy in place to manage liquidity even under stressed scenarios. A contingency plan is being established, detailing action plans and relevant procedures and responsibility of relevant departments. For details of the Group's actions taken in response to LM-2, please refer to Note 4.3 to the Financial Statements in this Annual Report.

TECHNOLOGY AND OPERATIONS

In 2012, the Group continued to strengthen its information technology and business operation infrastructure to support business growth and enhance operational efficiency. The Corporate Online Banking system has been revamped to provide a number of functionalities to improve customer experience. The linkage to BOC's global cash management platform was completed to facilitate local and cross-border fund pooling services to multinational enterprises, giving support to establish BOC Group's leading position in global cash management. The Centralised Limit Control and Customer Group Limit Management platform was established to support a more comprehensive review on credit monitoring, risk analysis and reporting. The core system of BOC Life was revamped to make use of additional parameters and simplifies the development of new life insurance products, resulting in development time reduction and time-to-market improvement.

CREDIT RATINGS

As at 31 December 2012	Long-term	Short-term
Standard & Poor's	A+	A-1
Moody's	Aa3	P-1
Fitch	A	F1

On 25 October 2012, Standard & Poor's affirmed the 'A+' long-term and 'A-1' short-term issuer credit ratings on BOCHK. The outlook is stable.

On 2 August 2012, Moody's affirmed 'Aa3' long-term and 'P-1' short-term local and foreign currency bank deposit ratings on BOCHK. The outlook is stable. The Bank Financial Strength Rating is 'C+'.

On 31 October 2012, Fitch Ratings affirmed 'A' long-term and 'F1' short-term foreign currency issuer default ratings on BOCHK. The outlook is stable.

RISK MANAGEMENT

Banking Group

Overview

The Group believes that sound risk management is crucial to the success of any organisation. In its daily operation, the Group attaches a high degree of importance to risk management and emphasises that a balance must be struck between risk control and business growth and development. The principal types of risks inherent in the Group's businesses are credit risk, interest rate risk, market risk, liquidity risk, operational risk, reputation risk, legal and compliance risk, and strategic risk. The Group's risk management objective is to enhance shareholder value by maintaining risk exposures within acceptable limits. The Group has a defined risk appetite statement approved by the Board, which is an expression of the types and level of risk that the Group is willing to take in order to achieve its business goals and to meet the expectations of its stakeholders under a controllable risk level. For details of the Group's risk management governance structure, please refer to Note 4 to the Financial Statements in this Annual Report.

Credit Risk Management

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

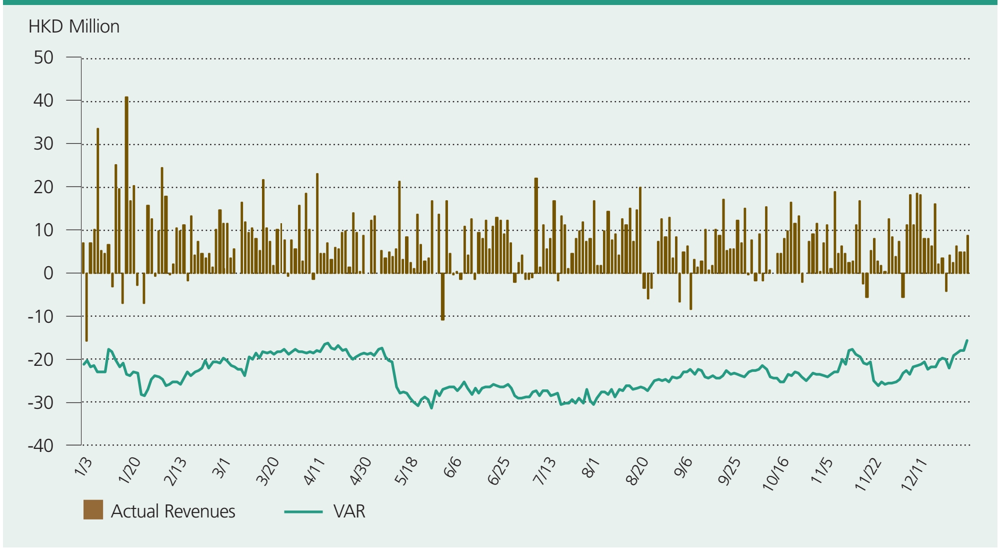
Market Risk Management

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

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

The predictive power of the VAR measure is monitored by back-testing, which compares the calculated VAR figure of market risk exposures of each business day with the actual and hypothetical revenues arising on those exposures 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. The graph below shows the back-testing result of the VAR against actual revenues of the Group.

Daily Back-testing in 2012



There were no actual losses exceeding the VAR estimates for the Group in 2012 as shown in the back-testing results.

Interest Rate Risk Management

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

Liquidity Risk Management

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

Operational Risk Management

Operational risk is the risk of loss resulting from inadequate or failed internal process, staff and information technology 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, self checking, self correction and self development. 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 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 robustness 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 prevent and manage reputation risk proactively at an early stage when an incident occurs. Since reputation risk is often caused by various types of operational and strategic issues that negatively impact the trust and perception of the Group, all operational and key risks identified are assessed through the established Key Control Self-Assessment framework, including risk assessment tools, to evaluate the severity of their impact on the Group, including the damage to reputation.

In addition, the Group has put in place a 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 judgements 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 Chief Risk Officer ("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 induce some 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 decisional strategies and lack of response to the market. 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 Asset and Liability Management Committee ("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 under Pillar I, and therefore minimum common equity CAR, minimum core CAR and the minimum CAR are determined. Meanwhile, an operating CAR Range has also been established which enables the flexibility for future business growth and efficiency of capital utilisation.

The Group has assessed the relevant impact and been well prepared for the implementation of Basel III capital standards which came into operation on 1 January 2013.

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 limit approved by the RC. The Financial Management Department reports the combined stress test results of the Group to the Board and RC regularly.

BOC Life

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

Insurance Risk Management

BOC Life is in the business of insuring against the risk of mortality, morbidity, disability, critical illness, accidents and related risks. These risks are managed through the application of underwriting policies and reinsurance 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 BOC Life's underwriting procedures.

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

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

Interest Rate Risk Management

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

Liquidity Risk Management

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

Credit Risk Management

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

- Default risk of bond issuers or the counterparties of structured products
- Credit spread widening as a result of credit migration (downgrade)
- Re-insurers' share of insurance unpaid liabilities
- Amounts due from re-insurers in respect of claims already paid
- Amount due from insurance contract holders
- Amount due from insurance intermediaries

BOC Life manages credit risk by placing limits on its exposure to each investment counterparty or group of counterparties. Such limits are subject to annual or more frequent review by the Management.

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