



11th Annual CLSA Investors' Forum 2004
14 September 2004

Delivering what we promise

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Good morning ladies and gentlemen. It is indeed a pleasure for me to address this annual forum today. I would especially like to extend a warm welcome to those of you who are here in Hong Kong for the first time.

I'm often asked by analysts and fund managers from overseas about the economic environment in Hong Kong. My response has been that if you want to get a sense of what our economy has been like in recent years, visit one of our most popular tourist attractions, Ocean Park, and take a ride on the roller coaster.

A roller coaster ride can be both fun and terrifying — in Hong Kong's case, though, it has just been terrifying. In the early and mid 90s, Hong Kong's economy was on an upswing. Then, the Asian financial crisis hit and our stock and property markets came crashing down. At the beginning of last year, we were slowly climbing back up out of recession, when the economy came tumbling down again with the outbreak of SARS.

However, now it appears that we are in for a smoother ride as evidenced by the latest economic figures.

In the second quarter of 2004, GDP went up by 12.1% in real terms compared with the low base of the same period last year and up 7.0% from the first quarter. This was the fastest year-on-year growth rate since the first quarter of the year 2000.

Unemployment was at a 28-month low of 6.9% in July, down from 7.4% at the end of last year.

And the deflation that plagued us for 68 consecutive months finally came to an end in July, with few signs of the upward price pressure that would lead to rapid inflation.

At the same time, consumer confidence has returned. Helped by the huge influx of tourists from mainland China under the individual travel scheme, retail spending for the first seven months of 2004 increased by 13.0% in value or 10.8% in volume, as compared with the same period last year.

External trade was nearly as vibrant with growth of 18.7% in real terms in the second quarter and 15% in the first quarter of 2004 over the same period last year. What's more, trade exports from the Mainland continued to be very strong, which is helpful to Hong Kong's re-export trade.

The government, therefore, has forecast that GDP for 2004 will grow by 7.5%, up 1.5 percentage points from its previous projection of 6%.

These are all encouraging results. But, we still have some concerns, such as volatile oil prices and rising US interest rates. The banking sector in Hong Kong will also face the prospect of squeezed margins and intense competition. To succeed, banks must continue to provide innovative products and outstanding service, while expanding their business in such high-growth areas as wealth management.

We deliver what we promise

I have said in the past that Hang Seng does not have an exciting story to tell. But there is one thing about us that you can count on — we deliver what we promise.

For the period from 1 January 1999 until 31 December 2003, we announced a target that would double shareholder value under our Managing for Value strategic plan. We not only met that target, we exceeded it. By investing in Hang Seng Bank during that period, our shareholders were able to enjoy total returns of 106.3%, a figure substantially higher than the 46.2% recorded by Hang Seng Index constituents for the same period. This was achieved during one of the most challenging periods in Hong Kong's recent history.

We also promised to increase wealth management income, and we delivered. We promised to grow our trade finance business, and we delivered. And we promised to expand on the Mainland through a two-pronged approach of forming strategic partnerships and pursuing organic growth. On both counts, we delivered.

We will continue to focus on creating value for our shareholders over the next five years through strong competitive growth in earnings per share and operating efficiency.

We've made a good start, as shown by our interim results for 2004. This was despite the difficult operating environment for banks in Hong Kong, owing to weak credit demand and squeezed interest margins.

Growth in the first half of 2004

During the first half of 2004, we delivered substantial gains in other operating income, most of which was derived from our wealth management business.

Attributable profit increased by HK\$1,223 million, or 24.4%, compared with the first half of 2003, to \$6,245 million. This was due mainly to a strong growth of 25.7% in other operating income, as well as a large release in provisions for bad and doubtful debts. Compared with the second half of 2003, attributable profit rose by \$1,728 million, or 38.3%.

Excluding the impact of the release in general provisions and the related deferred taxation, attributable profit increased by \$647 million, or 12.9%. This increase reflects the solid performance of our underlying business in a difficult operating environment.

The gains in other operating income amounted to \$688 million, which brought our other operating income to a total of \$3,362 million for a record 41.6% of total operating income.

Operating profit before provisions was \$6,096 million, an increase of 0.4%, compared with the first half of 2003 and 12.8% compared with the second half of 2003.

Return on average shareholders' funds was a record 30.9% and 6.4 percentage points higher than the cost:income ratio. Once again, the ROE was higher than our cost:income ratio.

The total distribution of dividends for the first half of 2004 was \$2.20 per share, a slight increase over the \$2.10 per share for the first half of 2003.

Total advances to customers, net of provisions, grew by 7.5% to \$246.8 billion, compared with an industry growth of 2.3%.

Net interest income, however, declined \$509 million or 9.8%. This was mainly due to the exceptionally low Hong Kong dollar interest rates, which reduced deposit spreads, and to fierce competition in the mortgage markets, which negatively impacted margins.

Net interest margin narrowed by 39 basis points to 2.02%, comprising a fall in net spread of 38 basis points and a decline of 1 basis point in contribution from net free funds.

In the current economic environment, our asset quality has improved with the ratio of gross non-performing advances to gross advances to customers dropping from 2.3% to 1.6%. Overdue advances dropped by 37.7% to \$2,060 million.

Operating expenses during this period increased 8.6% to \$1,977 million. This was mainly due to the investments we made in additional staffing, IT and marketing to capitalise on the business opportunities that arose after SARS. Nevertheless, our cost:income ratio of 24.5% continued to be among the lowest in the banking world.

Areas of strength

Our income from wealth management rose strongly in 2004, due mainly to positive investor sentiment in the active stock market that prevailed in the first part of the year.

Since January, we have successfully launched 18 new funds with capital protection and growth opportunities, as well as products designed to offer better returns in the low interest rate environment. This brought the total number of funds in the Hang Seng Investment Series to 108.

By the end of August, we recorded HK\$30 billion in sales of retail investment products, already surpassing our total for last year. Total funds under management by Hang Seng's asset management and our private banking business units grew by \$12.6 billion, or 21.7%, to \$70.4 billion at 30 June 2004.

Another strong performer was the insurance business. Insurance income went up by 17.8% to \$616 million, most of which was contributed by the life insurance business. In the first half of 2004, annualised life insurance premiums rose by 115.7% to nearly \$699 million. Our share of the life insurance market for this period, in terms of new annualised premiums concluded, was up from 7.7% in 2003 to 11%, giving us the number three position in the local market.

During the first six months of 2004, we were able to increase our trade finance business by about 40% to \$15,807 million from \$11,322 million at 31 December 2003, compared with an average industry growth rate of 22.1%.

Challenges and opportunities

The major challenges for Hong Kong banks are the lack of quality lending opportunities and excess liquidity, a flat lending market, and pressure on net interest margins.

There will also continue to be keen competition among banks and growing demand from customers, who are increasingly price sensitive.

Despite strong continued GDP growth on the Mainland, there are some concerns about increases in production costs due to power shortages, fuel costs and raw material costs. If production levels slow down as a result of these factors, exports and our re-export trade in Hong Kong could be affected.

At Hang Seng, we are well equipped to meet these challenges and to deliver value to our shareholders.

To improve the overall margin we will make a strong effort to grow lending in both our consumer and trade finance businesses, which should benefit from the expected rise in interest rates in the second half of 2004.

There is also very good potential for consumer financing in light of the improving economy. We have a large customer base comprising more than one-third of Hong Kong's population, which provides us with excellent cross-selling opportunities. What's more, our strong credit risk management and the implementation of consumer credit data sharing will enable us to better manage credit losses.

Wealth management will be another source of income growth, particularly in the high end segment of professionals, managers, executives and business owners. The potential of this market is enormous, given the growing affluence of Hong Kong people. As market sentiment remains positive, we will step up our Private Banking and Prestige Banking services to capture market opportunities and offer a wider range of products that meet different risk appetites.

We will also continue our growth momentum in the life insurance business by taking advantage of cross-selling opportunities and providing innovative products.

In an effort to enhance service delivery and reduce operating costs, we are focusing more and more on e-Banking. As of the end of July, e-Banking accounted for 26% of all transactions at Hang Seng, and the number of Hang Seng Personal e-Banking customers currently exceeds 400,000.

Mainland opportunities

Longer term, the Mainland offers excellent growth opportunities for us as well as for other Hong Kong based banks, now that China has gained acceptance into the WTO and is opening up its financial markets.

For Mainland banking institutions, it only makes sense to embrace Hong Kong as a source of expertise, capital and investment for upgrading their systems and technology.

Hong Kong's highly efficient and liquid capital markets can also help Mainland financial institutions tap foreign funds. In addition, Hong Kong can play a key role in the modernisation of China's financial system in anticipation of the Renminbi becoming fully convertible and the gradual relaxation of its capital controls.

For Hang Seng, the Mainland continues to be a primary focus of our expansion, particularly in the Pearl River Delta and major coastal cities.

Our Shanghai, Guangzhou and Shenzhen branches are already offering RMB services to foreign passport holders and residents of Hong Kong, Macau and Taiwan, as well as foreign-invested enterprises. We received approval for our Fuzhou branch to offer these services later in the year. And, our Shanghai, Guangzhou and Shenzhen branches have started offering RMB banking services to domestic companies on the Mainland.

Later this month we are going to open a sub-branch in the Gubei district of Shanghai, and we have received approval to prepare for the opening of our first sub-branch in Shenzhen. This will bring our network on the Mainland to five branches, three sub-branches and two representative offices in seven cities. We are also currently awaiting approval for the upgrading of our representative office in Beijing to a full branch.

We are now offering Hong Kong and overseas customers the opportunity to invest directly in Mainland A shares. This comes after our approval from the China State Administration of Foreign Exchange for an investment quota of US\$50 million to invest on the Mainland securities market and after the granting of a QFII Securities investment business permit by the China Securities Regulatory Commission.

We achieved a major breakthrough in our Mainland development with the acquisition of 15.98% of Industrial Bank for a total consideration of RMB1,726 million. Including the money we have put into our own branch network, our total investment on the Mainland is about RMB3 billion.

The acquisition represents a major step forward in our plan to grow through partnerships as well as organically. With our CFO now sitting on the Board of Industrial Bank, we will explore opportunities for offering credit card and unsecured personal loan businesses when the relevant regulations permit. We will also form joint ventures in certain consumer financing areas. When opportunities arise and regulations allow, we plan to cooperate further in auto financing and mortgages.

We are also open to investing in non-bank financial institutions on the Mainland, if the partner and pricing are right, and will consider any proposals within the allowed regulatory framework.

The deal with Industrial Bank is the second largest acquisition of a Mainland Bank, in terms of its cash value, next to that of the Bank of Communications Limited by The Hongkong and Shanghai Banking Corporation Limited. Our acquisition will significantly build up our market position on the Mainland, and I am quite confident that we are on the right track in terms of where we are going and in our timing.

I've touched on some of the issues that Hong Kong, the banking sector and Hang Seng have faced over the past few years. The economy has certainly taken a turn for the better in that time, and our recent financial performance not only reflects those improvements but also our strong fundamentals and operating efficiency.

Our performance is also a reflection of our successful approach to delivering value to our shareholders.

Thank you.