



10th Annual CLSA Investors' Forum
23 September 2003

Capturing Opportunities In A Challenging Environment

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Good morning ladies and gentlemen. May I say how delighted I am to be here today.

When I spoke at the CLSA Virtual Odyssey in May, the title of my presentation was 'Riding Out The Storm'. At that time, the adverse economic impact of SARS was significant, and the government and many economists had reduced their GDP forecasts for the territory.

However, following the success in bringing SARS under control, the Hong Kong government last month revised upwards its 2003 GDP forecast for the territory from 1.5% to 2% in real terms. Many economists also raised their forecasts.

Overall, economic activity began to bottom out towards the end of May. Yet despite signs of an economic rebound, the strength of the rebound is unclear and many challenges remain for Hong Kong. The government's revised 2% GDP forecast is still below its original GDP forecast of 3% for the year.

The title of my presentation today is 'Capturing Opportunities In A Challenging Environment'. Although there are some signs of light at the end of the economic tunnel and Hang Seng is poised to take advantage of this, difficulties remain in the economic and banking environments.

As a prudent yet progressive organisation, Hang Seng's sound fundamentals allowed it to report resilient results in the first half of 2003. We intend to further strengthen our market leadership in Hong Kong and become an important player in mainland China.

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The challenging environment

Hong Kong's GDP in the second quarter of 2003 slackened by a less than expected 0.5% in real terms over a year earlier. On a seasonally adjusted quarter-to-quarter comparison, the GDP fell by 3.7%.

The pick-up in the Hong Kong economy and in local confidence in recent months is welcome. The support of the Chinese government through the signing of the Mainland/Hong Kong Closer Economic Partnership Arrangement (CEPA) is also positive. We must not, however, lose sight of the many challenges facing the territory in its economic restructuring.

CEPA has formalised the convergence process of the two economies by dismantling barriers between the two places. Deeper economic convergence between Hong Kong and the Mainland has reaffirmed the territory's position as the gateway to the Mainland market.

The economic improvement has been most visible in inbound tourism and the travel-related sectors. With the relaxation in individual travel to Hong Kong by Mainland residents under CEPA, the territory has benefited from increased people and funds flow. The number of Mainland tourists is expected to grow from 6.8 million last year to 10 million in 2004.

Meanwhile, the external sector is expected to remain robust, given the improved global and regional economic outlook. The government has forecast that total exports of goods will rise by 9.2% in 2003.

The 1,521 personal bankruptcies declared in July was the lowest figure recorded in 17 months. The improved market sentiment has given a boost to property transactions and property prices appear to have stabilised.

Having said that, I must stress that Hong Kong's structural problems remain. Although important, tourism spending only accounts for about 6% of Hong Kong's GDP. Deflation, which was in its 57th month in July, is expected to last at least another year. Although the unemployment rate appears to be stabilising, it was a high 8.6% for the 3 months ending August and a skills mismatch continues in the labour market. The government also needs to find ways to solve the budget deficit problem through strict cost discipline in the public sector.

In order to reap long-term benefits, Hong Kong must grasp opportunities from the improved environment to speed up its structural changes.

Despite the signs of economic rebound, many difficulties remain in the banking sector. Even before the SARS outbreak, operating conditions were challenging, with narrowing interest margins and subdued loan demand. Total loans for use in Hong Kong contracted by 13.0% from 1998 to 2002. In the first seven months of 2003, loans for use in the territory fell further by 1.9%.

Nonetheless, Hang Seng is determined to create value by making the most of opportunities that arise.

Riding on the improving economy

Hang Seng's considerable strengths have positioned the Bank strongly to ride on the improving economy. In order to provide sustainable profitability, we intend to:

- Build on our financial strength
- Capitalise on our sound business fundamentals
- Increase wealth management services
- Focus on growth drivers and
- Expand in the Mainland.

Our financial strength

By market capitalisation, Hang Seng is the largest local bank listed in ex-Japan Asia and the second largest listed bank in Hong Kong.

Despite the effects of the SARS outbreak and sluggish economy in the first half of 2003, the Bank achieved a creditable growth in operating profit of 0.9% to HKD5,617 million, compared with the same period last year. This reflects the resilience of the Bank's core business.

Although attributable profit fell by 3.8% to HKD5,022 million, it represented a rise of 6.9% compared with the second half of last year.

The return on average shareholders' funds was 24.4%, compared with 24.1% in the same period last year.

In view of the Bank's strong balance sheet, the Directors declared a first interim dividend of HKD2.10 per share. Acknowledging the increasing importance of dividend flows to our shareholders, the Board has decided to move to a programme of quarterly dividends in 2004.

We made significant progress in expanding non-interest income and in managing costs. The ratio of other operating income to total operating income rose to a record 33.9% in the first half of 2003. This was an increase of 5 percentage points from the same period last year and of 11.4 percentage points from the same period in 1998.

The cost-to-income ratio, among the lowest in the banking world, improved to 23.1%. This was 0.6 percentage point lower than the same period last year and 4.1 percentage points below the level of the second half of last year.

Hang Seng continued to outperform the market in Hong Kong in many areas in the first half of 2003, according to figures released by the Hong Kong Monetary Authority (HKMA).

The Bank's net interest margin of 2.41% was favourable compared with the net interest margin of 1.97% recorded by retail banks in Hong Kong as a whole. Its low cost-to-income ratio of 23.1% was most attractive against the retail banks' average of 37.7%.

Reflecting the Bank's asset quality and prudent lending, its loans overdue for more than three months and rescheduled loans as a ratio of total loans were lower at 3.37%, compared with 3.61% for retail banks at the end of June. The Bank's non-performing loans of 2.5% compared favourably with 3.83% for retail banks.

The Bank's annualised charge-off ratio for its credit card business in the first half of this year was 8.85%, compared with 11.8% for institutions surveyed by the HKMA.

The Bank's financial strength allows it to take advantage of new business opportunities to continue to create value for shareholders.

Under our Managing for Value strategy, the Bank achieved a total return of 76.7% for shareholders from the start of 1999 until 15 September 2003. This was substantially more than the average return of 26.8% recorded by Hang Seng Index constituents over the same period. In absolute terms, total shareholder value increased by HKD101.5 billion.

The Bank's strong performance was recognised when it was named the Best Domestic Commercial Bank by The Asset and Asiamoney magazines in January and May respectively.

Sound business fundamentals

Our sound fundamentals provide a solid base for business expansion.

Hang Seng serves more than one-third of Hong Kong's population. We are developing our large customer franchise to establish and manage relationships so that they are economically viable. The focus is on satisfying total customer needs and gaining a high share of customer wallet penetration.

Segmentation has become an important means to deepen customer relationships. This was strengthened with the launch in June of Leisure Class lifestyle services for retirees and those who are planning to retire. Our integrated accounts have become a major platform to implement segmentation and increase product cross-selling.

Hang Seng is also building on its trusted brand, superior service and operating efficiency.

Highlighting our operating efficiency, attributable profit per employee in the first half of 2003 stood at HKD0.7 million. Our total staff number of about 7,200 at end-August was a reduction of about 840 from the height in 1997.

We offer an efficient multi-channel delivery network, with the emphasis on automation to enhance customer convenience and reduce costs.

Our e-Banking services have proved popular. At the end of August, the number of customers registered for Personal e-Banking services in Hong Kong was 305,000, an increase of 38% from the same period last year. The number of internet transactions had risen to 19.6% of total transactions, and online share trading to 58.3% of total securities transactions.

Growing wealth management services

There is increasing awareness of the need for lifetime wealth management among Hong Kong people. The improving economy is also encouraging greater financial spending by customers. We have done very well in this non-interest income business and we shall continue to increase our focus on this.

Income from wealth management, comprising income from investment and insurance services, grew strongly by 37.2% to HKD1,397 million in the first half of this year. It represented 52.2% of total other operating income.

Among our most successful products are the capital guaranteed funds under the Hang Seng Investment Series – the largest group of such funds in Hong Kong. At the end of August, the total number of capital guaranteed funds and the sub-funds under the Series for retail customers was 61 and 83 respectively. Funds managed under the Series increased by 25% to HKD28.9 billion in the first eight months of 2003, compared with the same period a year earlier.

Our securities business has also grown in recent months in line with the increase in market turnover.

In the aftermath of the SARS outbreak, our life insurance business has grown strongly. The industry as a whole paid out SARS-related claims of over HKD100 million, making Hong Kong people more aware of the need for insurance.

For the first half of this year, Hang Seng Life was ranked the No. 2 bancassurer in Hong Kong in terms of new business by annualised premiums.

Focus on growth drivers

We have put additional focus on a number of business areas, which are expected to benefit from the improving economy.

These include small and medium-sized enterprises (SMEs), trade finance and private banking, in addition to wealth management.

SMEs are the backbone of Hong Kong business and the Bank is expanding its customer base in this sector, partly by targeting business associations. Our cross-selling ratio for this group is improving.

Our objective is to provide total business solutions to our commercial customers and we shall soon launch an Integrated Business Solutions Account. This will offer one-stop financial services to businesses.

In the first half of this year, our trade finance rose by 13.1%, benefiting from the improvement in external trade. We intend to continue to take advantage of the robust external sector. Mainland China's export growth was about 30% for the 11 months up to July and such strong growth will benefit Hong Kong's re-exports.

To serve the trade finance needs of customers with business operations in Macau, we plan to open a branch there later this year.

We are also increasing our focus on private banking. Our aim is to become a leading domestic player in terms of assets under management, client base and profitability.

Expanding in the Mainland

We are committed to long-term development in the Mainland, particularly in the rapidly growing Pearl River Delta. Following the signing of CEPA, more Hong Kong companies, especially smaller firms, will move into the Mainland or expand their business with the Mainland. We shall follow our customers to capture business opportunities.

Later this year, the Guangzhou Branch will become our second branch to offer renminbi services in the Mainland, after Shanghai last year. We are expanding our trade services in Guangzhou so that we can further support the long-term business development of our commercial customers in both Hong Kong and the Pearl River Delta. We have also applied for our Shenzhen branch to offer renminbi services.

Last week, we formally opened our fifth branch in the Mainland, in Nanjing, which will help us expand in the economically important Yangtze River Delta.

We shall continue to grow our Mainland network with more branches and are currently preparing to open a sub-branch in Puxi, Shanghai.

Recent reports that the central government would be prepared to give foreign banks a greater stake in Mainland banks – as much as 20% compared with the present 15% -- are encouraging. Hang Seng has been looking to grow not just organically but by acquisition if the right partners can be identified. We have the advantage of being a world-class bank run by Chinese.

In other Mainland developments, our Guangzhou, Shanghai and Shenzhen branches began foreign currency services for mainland Chinese citizens and corporations, and opened Prestige Banking Centres for affluent customers last year.

Conclusion

As a premier financial services provider, Hang Seng's growth strategies will allow the Bank to capture new opportunities in the challenging environment.

Hang Seng is a fundamentally strong bank which this year marked its 70th anniversary. Its many strengths include prudent management, a large customer franchise, clear vision and efficient operations, and it is well positioned to build further on these.

Thank you.