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Hang Seng Bank: Targeting Long-Term Sustainable Growth

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Good morning, ladies and gentlemen. I am delighted to join you here at Morgan Stanley’s Tenth Annual Asia Pacific Summit to update you on developments at Hang Seng Bank.

Before we start, please note the cautionary words on forward-looking statements on the screen. All figures in this presentation are in Hong Kong dollars unless otherwise stated.

The presentation will be in three parts: our performance in the first half of this year, challenges and opportunities we face, and Hang Seng’s strengths and the strategic directions we are taking.

Financial Performance

We shall first look at our results.

We are enhancing our performance by shifting resources towards businesses where returns are commensurate with managed risks.

We are maintaining deposit-driven growth, a high quality portfolio with risk-based pricing, strong capital and liquidity, and cost discipline.

Despite the low interest rate environment, Hang Seng grew both net interest income, and net fees and commissions.

Operating profit excluding loan impairment charges rose by 6.4% to $7,287 million over the same period last year. Operating profit, at $7,129 million, grew by 6.5% from the first half of last year.

Profit before tax was $9,320 million, up 15% from the first half of last year.

Profit attributable to shareholders rose to $8,057 million, an increase of 15.7% compared with the same period last year. Earnings per share increased to $4.21, up 15.7%.

The Bank's continued investments to support business growth, capture business opportunities and increase employee compensation saw an 11% rise in operating expenses to $3,888 million from the first half of 2010. Excluding our Mainland business, operating expenses rose by 9.4%. Compared with the second half of last year, operating expenses were broadly unchanged. Our cost efficiency ratio in the first six months of this year was 34.6%. This figure is among the lowest in the banking world and compares favourably with the average 43.7% cost-to-income ratio recorded by the Hong Kong banking sector[1].

The dividend distribution for the first half of 2011 was $2.20 per share, the same as in the first half of last year.

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[1] Source: Half-Yearly Monetary and Financial Stability Report, Hong Kong Monetary Authority

Our return on average shareholders' funds was 22.7%, compared with 22.8% for the same period last year. The return on average total assets was maintained at 1.7%, compared with the 1.19% return on assets recorded by the Hong Kong banking sector over the same period[2].

Total assets grew by 6.1% to $973.2 billion as we continued to grow customer advances prudently.

At 30 June this year, our capital adequacy ratio was 13.8%, compared with 13.6% at the last year-end. The core capital ratio stood at 11%, slightly above the 10.8% at the end of last year.

Net interest income rose by 13.8% to $7,637 million compared with the same period last year, driven by the growth in average balances of trade finance, and corporate and personal lending.

The net interest margin for the first half of 2011 was 1.75%, down 2 basis points from the same period last year. The figure was partly affected by the narrowed deposit spread and the dilutive effect of the increase in lower yielding renminbi funds placed with the local clearing bank. It compares favourably with the industry average of 1.21% among the retail banks in Hong Kong[3].

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[2] Source: Half-Yearly Monetary and Financial Stability Report, Hong Kong Monetary Authority
[3] Source: Half-Yearly Monetary and Financial Stability Report, Hong Kong Monetary Authority

Net fees and commissions increased across most core businesses and grew by 7% to $2,536 million. We continued to build on our comprehensive wealth management capabilities. Income from the sales of retail investment funds increased by 12.2% in the first half of the year. Stockbroking and related services income rose by 3.4%. Fee income from private banking grew by 25.4% and from our credit card business by 6.7%. By leveraging global trade demand, our income from trade financing and remittance services recorded solid growth of 21.5% and 8.2% respectively.

Trading income rose by 4.6% to $931 million compared with the first half of last year.

Net operating income before loan impairment charges grew by 8.7% to $11,253 million. Loan impairment charges rose by $5 million year-on-year to $158 million. Reflecting our good credit risk management, total loan impairment allowances as a percentage of gross advances improved by 6 basis points to 0.33% at the end of June this year.

Gross advances grew by 6.5%, to $505.3 billion, compared with the end of last year due to our increased focus on trade finance and lending on the Mainland. Loans for use in Hong Kong rose by 0.5% to $350.4 billion.

Trade finance lending rose by 26%. The Bank was an active participant in Hong Kong Government-organised schemes to support SMEs.

Loans for use outside Hong Kong rose by 19.9% compared with the end of last year, driven partly by lending by Hang Seng China.

Deposits, including certificates of deposit and other debt securities in issue, rose by 4.3% to $740.8 billion at the end of June this year.

Customer Segments

Let’s turn to Hang Seng’s key customer segments.

Retail Banking and Wealth Management reported profit before tax of $3,457 million in the first half of this year.

Although top line business momentum sustained good performance, operating income excluding loan impairment charges declined by 3.5% year-on-year to $6,062 million. This was due to the higher costs of deposits, the holding back of growth of mortgage loans and the lower investment return of the life insurance portfolio.

In the strongly competitive environment, Hang Seng had to offer high interest rates to maintain customer relationships. The impact on our deposit income saw net interest income from deposits drop by 17.1% compared with the same period last year.

Total operating income from unsecured lending was up 10% year-on-year, benefiting from a high quality credit card customer base and targeted marketing campaigns. The increase in card income was supported by a year-on-year increase of 14.7% in the number of cards in circulation to 2.19 million. Card spending grew by 17.5% and card receivables by 4%.

Income from secured lending recorded a year-on-year decline. Despite intense market competition, our mortgage business remained third in the market in terms of new mortgage registrations for the first half of this year.

Investment businesses remained a strong income driver and investment fund subscriptions grew by 30.8% to reach $21 billion. Funds under management, including private banking, rose by 5% from the end of last year and exceeded $160 billion for the first time.

Commercial Banking delivered a 34% increase in profit before tax, reaching $2,389 million. Operating profit excluding loan impairment charges grew by 30.8% to $1,631 million.

This strong growth resulted from our focus on account acquisition, further enhancement of our cross-border services, and provision of competitive corporate wealth management products to meet customer needs.

In line with the increase in the loan portfolio both in Hong Kong and the Mainland, net interest income from advances increased by 50.4%. Non-interest income rose by 11.5%.

The Bank has an edge in cross-border transactions. The close co-operation between our Hong Kong and Mainland teams and the alliance with several strategic partners on the Mainland supported customers in growing their cross-border business and the establishment of a dynamic customer referral channel.

Corporate Banking posted a 61.6% growth in profit before tax to $905 million compared with the first half of last year. Operating profit excluding loan impairment charges was up 54.5% at $859 million.

Corporate Banking diversified its customer advances portfolio. Against a backdrop of tightening market liquidity, it leveraged its strong industry knowledge, effective risk management and dedicated business teams in Hong Kong and on the Mainland.

Treasury registered an increase in profit before tax of 31% to $1,873 million compared with the same period last year. Operating profit rose by 38.5% to $1,284 million.

Although global interest rates remained at low levels and yield curves were relatively flat, net interest income rose by 69.5%, mainly due to our strategy of actively managing our balance sheet. Foreign exchange as well as securities and derivatives trading achieved strong growth, boosted largely by rising demand for renminbi products.

Mainland Business

Our wholly-owned subsidiary, Hang Seng Bank (China) Limited recorded growth of 160.1% in profit before tax compared with the first half of last year, driven by strong revenue growth.

In the very challenging market, Hang Seng China increased its deposit base, acquired new customers, widened the loan margin and boosted other operating income. Advances rose by 10.5% to $40.2 billion from the last year-end. Total deposits increased by 20.5% over the same period.

The number of personal customers jumped by 22.2% year-on-year. Targeting customers with cross-border renminbi business and trade services needs, the number of corporate customers also grew by 13.3% year-on-year.

Total operating income rose by 43.9% over the same period last year, supported by the increase in both net interest income and other operating income.

Our strategic alliance with Industrial Bank continued to support the Bank's long-term growth on the Mainland. Our share of profit from associates grew by 49.6% to $1,771 million, mainly from Industrial Bank. In March, the Bank signed a memorandum of understanding with Industrial Bank to further strengthen bilateral cooperation.

In an important milestone, Hang Seng China moved in May into new headquarters which we acquired last year in Shanghai's Lujiazui financial district. The move signifies our long-term commitment to development on the Mainland.

We continue to expand our Mainland network. In August, we opened a cross-city sub-branch in Huizhou, Guangdong. The Bank has applied to establish a branch in Xiamen.

Hang Seng Securities Limited has also applied jointly with Guangzhou Securities Company Limited to set up the first joint venture securities investment advisory company in Guangdong province under Supplement VI to CEPA.

The next section looks at the challenges we face and the opportunities open to us.

Economic indicators, particularly in developed countries, are worrying. Since the third quarter of this year, the euro zone sovereign debt crisis has deepened. Recovery in the US economy has slowed. Credit ratings for the US and various European countries have been downgraded. The economic uncertainties have resulted in increasing volatility in the financial markets around the world, and dampened consumption and investment appetites.

Against this backdrop, economic growth in China and Hong Kong is moderating.

In China, GDP growth in 2011 is expected to be lower than the 10.4% recorded last year. In the first three quarters of this year, it stood at 9.4%.

Export growth slowed to 22.7% in the first three quarters of this year from 34% in the same period last year. The trade surplus narrowed slightly to USD111.9 billion in the first three quarters, compared with USD120.9 billion in the same period last year.

The government maintains tight monetary policies in order to slow down price increases in food and property. Inflation remains high but appears to have peaked in July, slowing for the third consecutive month in October to 5.5%.

We thus expect to see a soft landing. We expect the economy to continue to advance steadily on the back of strong investment and consumption growth. The central government’s GDP growth target of 8% for this year will most likely be exceeded again.

In Hong Kong, with low unemployment, domestic consumption remains resilient. However, rising uncertainty about the global economy is expected to weigh on consumption and investment in the territory. The value of Hong Kong's total exports of goods in September contracted for the first time since 2009, by 3% over a year earlier and by 12.3% from August this year. With the peg to the US dollar and the decline of the US dollar against other currencies in the past year, inflation is a major concern. It is expected to reach 5.2% this year, which is the highest annual rate since 1997. The government forecast is for real GDP growth of 5% this year, compared with 7% last year.

Banks have been under pressure from low interest rates and narrowing net interest margins amid intense competition and rising cost pressure.

In this tough operating environment, Hang Seng Bank is adhering closely to its core strategy of financial prudence, and identifying appropriate opportunities to attain long-term sustainable growth.

Capitalising on RMB Liberalisation

The further liberalisation of the RMB is offering great opportunities for Hong Kong.

Hong Kong is strategically positioned as China's global financial centre and the major offshore RMB centre. In August, Vice-Premier of the State Council, Mr Li Keqiang, visited Hong Kong and announced a series of measures to strengthen the city's role in the internationalisation of the RMB.

The RMB market has been developing rapidly in Hong Kong. In September alone, the amount of RMB deposits rose month-on-month by 2.2% to reach RMB622.2 billion and was more than four times the amount a year earlier. The amount of RMB loans in the territory increased from less than RMB2 billion at the start of this year to about RMB15 billion at the end of August.

Hang Seng is a key player and pioneer in the provision of RMB products and services in Hong Kong. We were the first in Hong Kong to launch RMB payroll services; issue RMB certificates of deposit for retail customers; and lead-arrange an RMB syndicated loan. We were also the first non-Mainland fund manager to offer an RMB bond investment fund in Hong Kong.

As the RMB evolves from a cross-border settlement currency to a cross-border investment currency, Hang Seng is well-positioned to take advantage of the new opportunities.

Vice-Premier Li announced that Hong Kong companies can make direct investments in RMB on the Mainland. The details were announced in October and we expect a significant increase in demand by Hong Kong and international enterprises for RMB financing in the territory. Hang Seng will be able to capitalise on this demand through vigorous participation in RMB bilateral and syndicated loans, and the development of the RMB bond and securities markets. This will allow us to profitably deploy the RMB deposits we have garnered over the years.

The extension of cross-border trade settlement in RMB from 20 municipalities and provinces to the whole of China is good news. In Hong Kong, the amount of cumulative remittances for RMB cross-border trade settlement jumped to RMB1,700 billion in September and was 15 times the amount a year earlier. Trade settlement services are a pillar of Hang Seng's corporate and commercial banking services and we shall continue to focus on this.

Vice-Premier Li's announcement also included new policies that will strengthen Hong Kong's position in wealth and asset management. A RMB20 billion quota has been announced for Hong Kong companies to invest in securities on the Mainland via a RMB-denominated QFII scheme. This scheme will provide additional channels for us to deploy funds, and will in turn allow us to develop more innovative wealth management products for our RMB customers.

Mainlanders will also be allowed to invest indirectly in the Hong Kong stock market via index-tracking ETFs. Hang Seng is Hong

Kong's leading index compiler producing the Hang Seng Family of Indexes that cover both the Hong Kong and Mainland markets. We also manage ETFs that are dual listed in Hong Kong and Taiwan. Hang Seng hopes to play a major role in this area.

Conclusion

To summarise, Hang Seng is targeting growth and is well-positioned to capture opportunities in the market.

Despite the uncertain economic environment, Hang Seng has a clear strategic direction. We shall continue to build on our competitive strengths, maintain prudent risk management and capitalise on new opportunities to achieve long-term sustainable growth.

We seek to ensure the high quality of our assets and deepen relationships with our loyal customer base.

We shall continue to improve cost-efficiency through re-engineering, resource optimisation and further developing our technology platform while investing for future growth.

Growing our fee income will be important as we provide total solutions to customers across all businesses. In our personal banking business, we shall continue to grow our customer base, and expand our wealth management services and private banking. We shall also increase our presence in the SME sector.

As Hong Kong strengthens its role as China's global financial centre, we shall seek to further expand our range of RMB products and services both on the Mainland and Hong Kong.

We shall continue to enhance our cross-border services that provide a valuable source of referral business. On the Mainland, we shall continue to expand our network and develop new customer relationships.

Our goal is to become the leading personal and private bank for affluent and middle-class customers in Hong Kong and on the Mainland; and the leading trade bank in Greater China.

Hang Seng Bank has undisputed key strengths. We have a trusted brand, and offer excellent services to our customers. We are highly profitable. We have a solid position and maintain sizeable market share in key market segments. We have excellent cross-border market knowledge and time-to-market capabilities. Our strengths have won us recognition as Hong Kong's top local bank. In June, we were named Best Domestic Bank in Hong Kong for the third time by *Asiamoney,* an award that endorsed our success in meeting changing customer needs. In October, our financial prudence was highlighted when we were named House of the Year, Hong Kong, in the Asia Risk Awards. Also in October, Hang Seng became the first local bank in Hong Kong to be included as a constituent stock on the Dow Jones Sustainability Asia Pacific Index.

Given the above, we are confident that our business strategies will continue to drive long-term sustainable growth for Hang Seng. Thank you.