

CONTENTS

	<i>PAGE</i>
Report of the Directors	3
Corporate Governance	7
Report of the Auditors	11
Consolidated Profit and Loss Account	12
Consolidated Balance Sheet	13
Balance Sheet	14
Consolidated Statement of Changes in Equity	15
Statement of Changes in Equity	16
Consolidated Cash Flow Statement	17
Notes to the Accounts	
(1) Principal activities	18
(2) Basis of preparation	18
(3) Principal accounting policies	19
(4) Interest income	29
(5) Other operating income	29
(6) Operating expenses	30
(7) Charge for bad and doubtful debts	30
(8) Net loss from disposal/revaluation of fixed assets	31
(9) (Provision)/write-back of provision for impairment on held-to-maturity securities and investment securities	31
(10) Taxation	32
(11) Profit attributable to shareholders	33
(12) Dividends	33
(13) Retirement benefit costs	34
(14) Share option schemes	34
(15) Directors' and senior management's emoluments	37
(16) Cash and short-term funds	38
(17) Certificates of deposit held	38
(18) Held-to-maturity securities	39
(19) Investment securities	40
(20) Other investments in securities	41
(21) Advances and other accounts	42
(22) Provisions for bad and doubtful debts	43
(23) Investments in subsidiaries	46
(24) Investments in associates	47
(25) Fixed assets	49

(26) Hong Kong SAR currency notes in circulation	52
(27) Deposits from customers	52
(28) Assets pledged as security	53
(29) Other accounts and provisions	53
(30) Deferred taxation	54
(31) Share capital	54
(32) Reserves	55
(33) Notes to consolidated cash flow statement	55
(34) Maturity profile	58
(35) Off-balance sheet exposures	62
(36) Capital commitments	66
(37) Operating lease commitments	67
(38) Litigation	68
(39) Loans to directors and officers	68
(40) Significant related party transactions	69
(41) Ultimate holding company	75
(42) Approval of accounts	75

Unaudited Supplementary Financial Information

(1) Capital adequacy	76
(2) Components of capital base after deductions	77
(3) Liquidity ratio	78
(4) Currency concentrations	78
(5) Segmental information	79
(6) Cross-border claims	85
(7) Overdue and rescheduled assets	87
(8) Repossessed assets held	89
(9) Risk management	89

Report of the Directors

The directors are pleased to present their report together with the audited consolidated accounts of Bank of China (Hong Kong) Limited (the “Bank”) and its subsidiaries (together with the Bank hereinafter referred to as the “Group”) for the year ended 31 December 2002.

Principal activities

The Bank is a licensed bank authorised under the Hong Kong Banking Ordinance. The principal activities of the Group are the provision of banking and related financial services. An analysis of the Group’s performance for the year by business segments is set out in note 5 to the unaudited supplementary financial information.

Results and appropriations

The results of the Group for the year ended 31 December 2002 are set out in the consolidated profit and loss account on page 12.

On 18 June 2002, the directors declared a first interim dividend of approximately HK\$0.045 per ordinary share, totaling approximately HK\$1,937 million, which was paid on 28 June 2002.

On 27 December 2002, the directors declared a second interim dividend of HK\$0.06 per ordinary share, totaling approximately HK\$2,583 million, which will be paid on 5 May 2003.

Reserves

Details of the reserves of the Group and the Bank are set out in note 32 to the accounts.

Donations

Charitable and other donations made by the Group during the year amounted to approximately HK\$4,625,000 (2001: HK\$372,000).

Fixed assets

Details of the movements in fixed assets of the Group and the Bank are set out in note 25 to the accounts.

Share capital

Details of the share capital of the Bank are set out in note 31 to the accounts.

Report of the Directors (continued)

Directors

The directors of the Bank during the year and up to the date of this report are :

Executive Director

LIU Jinbao (Vice-chairman and Chief Executive)

Non-executive Directors

LIU Mingkang (Chairman)

SUN Changji (Vice-chairman)

PING Yue

HUA Qingshan

LI Zaohang

HE Guangbei

ZHOU Zaiqun

ZHANG Yanling

Independent Non-executive Directors

CHIA Pei-Yuan

FUNG Victor Kwok King

SHAN Weijian

TUNG Chee Chen

There being no provision in the Bank's Articles of Association for retirement by rotation, all the directors continue in office.

Report of the Directors (continued)

Directors' rights to acquire shares

On 5 July 2002, the following directors were granted options by BOC Hong Kong (BVI) Limited ("BOC (BVI)"), an indirect holding company of the Bank, pursuant to a Pre-Listing Share Option Scheme to purchase from BOC (BVI) an aggregate of 13,737,000 existing issued shares of BOC Hong Kong (Holdings) Limited ("BOCHK (Holdings)"), the immediate holding company of the Bank, at a price of HK\$8.50 per share. None of these options may be exercised within one year from 25 July 2002. These options have a vesting period of four years from 25 July 2002 with a valid exercise period of ten years. 25% of the number of shares subject to such options will vest at the end of each year. No offer to grant any options under the Pre-Listing Share Option Scheme may be made on or after 25 July 2002, the date on which dealings in the shares of BOCHK (Holdings) commenced on The Stock Exchange of Hong Kong Limited ("Stock Exchange").

Particulars of the options granted to the directors under the Pre-Listing Share Option Scheme are set out below:

	Date of grant	Exercise price (HK\$)	Exercisable period	Number of share options				
				Balances at 1 January 2002	Granted on 5 July 2002	Exercised during the year	Lapsed during the year	Balances at 31 December 2002
LIU Mingkang	05 July 2002	8.50	25 July 2003 to 04 July 2012	—	1,735,200	—	—	1,735,200
SUN Changji	05 July 2002	8.50	25 July 2003 to 04 July 2012	—	1,590,600	—	—	1,590,600
LIU Jinbao	05 July 2002	8.50	25 July 2003 to 04 July 2012	—	1,735,200	—	—	1,735,200
PING Yue	05 July 2002	8.50	25 July 2003 to 04 July 2012	—	1,446,000	—	—	1,446,000
HUA Qingshan	05 July 2002	8.50	25 July 2003 to 04 July 2012	—	1,446,000	—	—	1,446,000
LI Zaohang	05 July 2002	8.50	25 July 2003 to 04 July 2012	—	1,446,000	—	—	1,446,000
HE Guangbei	05 July 2002	8.50	25 July 2003 to 04 July 2012	—	1,446,000	—	—	1,446,000
ZHOU Zaiqun	05 July 2002	8.50	25 July 2003 to 04 July 2012	—	1,446,000	—	—	1,446,000
ZHANG Yanling	05 July 2002	8.50	25 July 2003 to 04 July 2012	—	1,446,000	—	—	1,446,000
Total:				—	13,737,000	—	—	13,737,000

Report of the Directors (continued)

Directors' rights to acquire shares (continued)

Save as disclosed above, at no time during the year was the Bank or its holding companies, or any of its subsidiaries or fellow subsidiaries a party to any arrangement to enable the directors to acquire benefits by means of the acquisition of shares in, or debentures of, the Bank or any other body corporate.

Directors' interests in contracts of significance

No contracts of significance, in relation to the Group's business to which the Bank, its holding companies or any of its subsidiaries or fellow subsidiaries was a party and in which a director had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

Management contracts

There exists a services agreement between BOCHK (Holdings) and the Bank whereby BOCHK (Holdings) provides management and investor relations services to the Bank and under which costs are reimbursed and fees are payable. The said agreement can be terminated by either party giving not less than three months' prior notice.

Compliance with the guideline on "Financial Disclosure by Locally Incorporated Authorized Institutions"

The accounts for the year ended 31 December 2002 fully comply with the requirements set out in the guideline on "Financial Disclosure by Locally Incorporated Authorized Institutions" under the Supervisory Policy Manual issued by the Hong Kong Monetary Authority ("HKMA").

Auditors

The accounts have been audited by PricewaterhouseCoopers. A resolution for their re-appointment as auditors for the ensuing year will be proposed at the forthcoming Annual General Meeting.

On behalf of the Board



Mr. LIU Mingkang
Chairman

Hong Kong, 20 March 2003

Corporate Governance

We have established a sound corporate governance framework with reference to the international “Best Practices” and applicable guidelines and rules of HKMA, following the guiding principles that we are accountable to all shareholders and are committed to maximising shareholder value and enhancing information transparency. With the Board of Directors (the “Board”) playing a pivotal role, the framework leverages on the supervisory functions of the Independent Non-executive Directors and combines the collective decision making of the Board and the personal liabilities of individual directors to create the most appropriate form of corporate governance.

Board of Directors and the Management

The Board is responsible for formulating the Bank’s overall strategies and targets with a view to enhancing shareholder value and to monitoring and providing guidance to our Management. Of the thirteen members on the Board, four are Independent Non-executive Directors whose primary function is to provide independent scrutiny and to ensure the protection of minority shareholders’ interests. The remaining members comprise eight Non-executive Directors and one Executive Director who also serves as the Chief Executive. In addition, we have engaged a senior adviser who is very experienced and knowledgeable in regulatory matters and capital market operations. He sits in on Board meetings and gives his opinion on matters discussed there. The Chief Financial Officer (“CFO”) and the Chief Risk Officer (“CRO”) also attend Board meetings to advise on matters relating to accounting, finance and risk management.

The positions of the Chairman and the Chief Executive are held by separate individuals and their roles are distinct. The Board, under the leadership of the Chairman, is responsible for the appointment and dismissal of the Chief Executive and other principal senior executives. The appointment and dismissal of other senior executives require the Board’s endorsement. Although the Chief Executive is authorised by the Board to manage the day-to-day business operations of the Bank in accordance with risk management and other internal control policies and procedures approved by the Board, major transactions, acquisitions, disposals of assets and investments have to be reviewed and approved by the Board. Both the Board and the Management have clearly defined authorities and responsibilities under various internal control and check and balance mechanisms. At the instruction of the Board, the Management has implemented appropriate measures and internal control procedures to ensure that we operate within applicable legal and regulatory requirements with prudence and a high level of integrity. To ensure effective discharge of the Board’s responsibilities, the Management submits reports on the Bank’s operations to the Board on a regular basis.

The Board is responsible for setting and closely monitoring the Bank’s overall long term development strategies, medium term business development plans and short term implementation steps. If necessary, it also adjusts the same with a view to enhancing shareholder value. The Management, under the leadership of the Chief Executive, is responsible for implementing the aforesaid strategies, plans and steps and for reporting the progress to the Board on a regular basis. The Board reviews and approves the Bank’s annual budget and business plan, which serve as important yardsticks in assessing the performance of the Management.

Corporate Governance (continued)

Board of Directors and the Management (continued)

The Board has established the Audit Committee, the Risk Management Committee (“RMC”) and the Remuneration Committee to focus and report to the Board on specific issues in relation to the Bank’s management and operation. During adjournment of the Board, these Committees monitor the Management’s performance on behalf of the Board. The Audit Committee has set up a Compliance Committee while the RMC has set up a Risk Control Committee (“RCC”), both of which comprise experts and professionals in the relevant field to assist the Audit Committee and the RMC in the discharge of their respective responsibilities.

The Management has set up various committees to assist it in decision making and to act as check and balance. These committees include the Management Committee, Asset and Liability Management Committee (“ALCO”), Credit Committee, Anti-money Laundering Committee and Information Technology Committee.

Audit Committee and Compliance Committee

The Audit Committee consists of seven Non-executive Directors, four of whom, including the chairman, are Independent Non-executive Directors. The members of the Audit Committee are: Mr. Shan Weijian (Chairman), Mr. Chia Pei-Yuan, Dr. Fung Victor Kwok King, Mr. Tung Chee Chen, Mr. Ping Yue, Mr. He Guangbei and Mr. Zhou Zaiqun. In addition to assisting the Board in fulfilling its oversight responsibilities, the functions of the Audit Committee also include reviewing significant accounting policies and supervising the Bank’s financial reporting process; monitoring the performance of both the internal and external auditors; reviewing and examining the effectiveness of the Bank’s financial reporting procedures and internal control; ensuring compliance with applicable statutory accounting and reporting requirements, legal and regulatory requirements, and internal rules and procedures approved by the Board. The Head of the Internal Audit Department reports directly to the Board and to the Audit Committee.

The Audit Committee has set up the Compliance Committee, which consists of six members, all of whom are experienced professionals in the legal or accounting fields. The members of the Committee are: Ms. Tang Xinyu (Chairman), Mr. Yeung Jason Chi Wai (Vice Chairman), Ms. Liu Yanfen, Ms. Wang Qi, Mr. Chiu Ming Wah and Mr. Tang Chin Tong. The Compliance Committee is responsible for monitoring the Bank’s legal and compliance matters and reporting to the Audit Committee in this respect.

Corporate Governance (continued)

Risk Management Committee and Risk Control Committee

In order to streamline the operations of the RMC, membership of the Committee has been reduced from thirteen members to eight. These members comprise four Non-executive Directors (including an Independent Non-executive Director), our Chief Executive, our CRO, and two other persons experienced in risk management. The members of the Committee are: Mr. Liu Mingkang (Chairman), Dr. Liu Jinbao, Mr. Chia Pei-Yuan, Mr. Hua Qingshan, Ms. Zhang Yanling, Mr. Chen Siqing, Mr. Dong Jianyue and Mr. Mao Xiaowei. The Committee provides independent support to the Board in formulating and monitoring compliance with the Bank's risk management policies, procedures and their implementation. The CRO reports directly to the Board and to the RMC.

The RMC has set up the RCC, which consists of nine members who are experienced in the areas of risk management, management of non-performing loans ("NPLs"), retail or corporate banking business. The members of the Committee are: Ms. Zhang Yanling (Chairman), Mr. Chen Siqing, Mr. Zhu Xinqiang, Mr. Gao Yingxin, Mr. Dong Jianyue, Mr. Zhang Weidong, Ms. Zheng Xiaomin, Mr. Or Man Ah and Mr. Mao Xiaowei. The Committee advises the RMC on the Bank's risk management policies and procedures and monitors their implementation.

Remuneration Committee

The Remuneration Committee consists of five Non-executive Directors, three of whom are Independent Non-executive Directors. The functions of the Committee include reviewing human resources management policies, examining remuneration strategies, determining the compensation of senior executives and managers, setting annual as well as long term performance targets for key management positions, and reviewing and monitoring the implementation of all executive compensation and benefits plans, in order to ensure that our remuneration packages are in line with our culture, strategies and regulatory requirements. The members of the Remuneration Committee are: Mr. Sun Changji (Chairman), Dr. Fung Victor Kwok King, Mr. Tung Chee Chen, Mr. Shan Weijian and Mr. Li Zaohang.

Internal Audit

We have implemented appropriate policies and procedures for all our major operations. Our internal audit is responsible for monitoring compliance with such policies and procedures. The primary objective of our internal audit is to assist the Board and the Management in the areas of risk management, and in monitoring compliance with applicable regulatory requirements and guidelines with a view to enhancing the effectiveness of our internal control mechanisms. All audit missions set out in the 2002 Audit Plan have been accomplished. The recommendations made by our internal audit in connection with such audit missions have been widely accepted and rectification measures have been put in place. Our internal audit also actively participates in the review and enhancement of our internal policies and procedures on a continuous basis.

Corporate Governance (continued)

Incentive Scheme and Corporate Culture

Through the establishment of a performance charter for our senior executives, appropriate appraisal mechanisms, and the Share Option Scheme and Sharesave Plan, we have been able to align the interests of our Management and entire staff with the growth and performance of the Bank. We have done this with a view to providing appropriate incentives to our Management and staff and to attracting and retaining key executives. We pay particular attention to the establishment of an optimal corporate culture. With the full support of the Management, we will identify, design and implement a corporate culture that is in compliance with regulatory requirements applicable to listed banks and that is considered appropriate for the special circumstances of our Bank, thereby ensuring that good corporate governance is maintained at all levels within the Bank.

REPORT OF THE AUDITORS

AUDITORS' REPORT TO THE SHAREHOLDERS OF BANK OF CHINA (HONG KONG) LIMITED (incorporated in Hong Kong with limited liability)

We have audited the accounts set out on pages 12 to 75 which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of directors and auditors

The Hong Kong Companies Ordinance requires the directors to prepare accounts which give a true and fair view. In preparing accounts which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently.

It is our responsibility to form an independent opinion, based on our audit, on those accounts and to report our opinion to you.

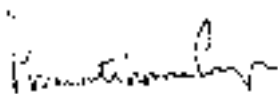
Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the circumstances of the Bank and the Group, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the accounts are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the accounts. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion the accounts give a true and fair view of the state of affairs of the Bank and of the Group as at 31 December 2002 and of the profit and cash flows of the Group for the year then ended and have been properly prepared in accordance with the Hong Kong Companies Ordinance.



PricewaterhouseCoopers
Certified Public Accountants

Hong Kong, 20 March 2003

Consolidated Profit and Loss Account

For the year ended 31 December

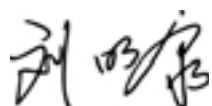
	Note	2002 HK\$m	2001 HK\$m
Interest income	4	21,463	38,307
Interest expense		(7,521)	(23,320)
Net interest income		13,942	14,987
Other operating income	5	4,177	4,022
Operating income		18,119	19,009
Operating expenses	6	(6,029)	(5,847)
Operating profit before provisions		12,090	13,162
Charge for bad and doubtful debts	7	(2,855)	(7,412)
Operating profit after provisions		9,235	5,750
Restructuring costs		—	(937)
Net loss from disposal/revaluation of fixed assets	8	(995)	(1,237)
Net gain from disposal of held-to-maturity securities and investment securities		—	20
(Provision)/write-back of provision for impairment on held-to-maturity securities and investment securities	9	(7)	24
Net gain on disposal of subsidiaries		—	12
Provision for impairment on investments in associates/ gain on disposal of associates		(27)	20
Share of operating (losses)/profits of associates		(100)	81
Profit before taxation		8,106	3,733
Taxation	10	(1,268)	(832)
Profit after taxation		6,838	2,901
Minority interests		(127)	(133)
Profit attributable to shareholders	11	6,711	2,768
Dividends	12	4,520	—

Consolidated Balance Sheet

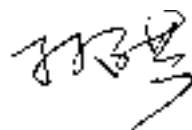
As at 31 December

	Note	2002 HK\$m	2001 HK\$m
ASSETS			
Cash and short-term funds	16	115,075	196,255
Placements with banks and other financial institutions maturing between one and twelve months		80,159	80,773
Trade bills		592	382
Certificates of deposit held	17	17,528	19,474
Hong Kong SAR Government certificates of indebtedness		29,110	25,510
Held-to-maturity securities	18	94,227	50,988
Investment securities	19	46	44
Other investments in securities	20	64,360	56,169
Advances and other accounts	21	308,332	308,108
Investments in associates	24	483	416
Fixed assets	25	20,212	21,049
Other assets		5,374	6,972
Total assets		735,498	766,140
LIABILITIES			
Hong Kong SAR currency notes in circulation	26	29,110	25,510
Deposits and balances of banks and other financial institutions		29,957	55,295
Deposits from customers	27	600,977	606,428
Certificates of deposit issued		—	5,000
Other accounts and provisions	29	19,983	20,671
Total liabilities		680,027	712,904
CAPITAL RESOURCES			
Minority interests		1,114	1,066
Share capital	31	43,043	43,043
Reserves	32	11,314	9,127
Shareholders' funds		54,357	52,170
Total capital resources		55,471	53,236
Total liabilities and capital resources		735,498	766,140

Approved by the Board of Directors on 20 March 2003 and signed on behalf of the Board by:



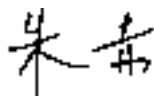
Mr. LIU Mingkang
Director



Mr. SUN Changji
Director



Dr. LIU Jinbao
Director



Mr. ZHU Chi
Deputy Chief Executive

Balance Sheet

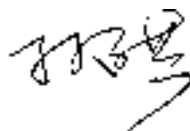
As at 31 December

	Note	2002 HK\$m	2001 HK\$m
ASSETS			
Cash and short-term funds	16	90,757	168,712
Placements with banks and other financial institutions maturing between one and twelve months		60,329	61,647
Trade bills		222	139
Certificates of deposit held	17	15,899	18,062
Hong Kong SAR Government certificates of indebtedness		29,110	25,510
Held-to-maturity securities	18	74,038	32,675
Investment securities	19	34	7
Other investments in securities	20	64,293	55,982
Advances and other accounts	21	263,729	264,354
Investments in subsidiaries	23	13,800	13,364
Investments in associates	24	490	328
Fixed assets	25	15,631	16,728
Other assets		5,579	6,473
Total assets		633,911	663,981
LIABILITIES			
Hong Kong SAR currency notes in circulation	26	29,110	25,510
Deposits and balances of banks and other financial institutions		30,189	53,430
Deposits from customers	27	504,342	511,507
Certificates of deposit issued		—	5,000
Other accounts and provisions	29	17,374	17,285
Total liabilities		581,015	612,732
CAPITAL RESOURCES			
Share capital	31	43,043	43,043
Reserves	32	9,853	8,206
Shareholders' funds		52,896	51,249
Total liabilities and capital resources		633,911	663,981

Approved by the Board of Directors on 20 March 2003 and signed on behalf of the Board by:



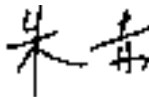
Mr. LIU Mingkang
Director



Mr. SUN Changji
Director



Dr. LIU Jinbao
Director



Mr. ZHU Chi
Deputy Chief Executive

Consolidated Statement of Changes in Equity

For the year ended 31 December

	Share capital	Merger reserve	Premises revaluation reserve	Investment properties revaluation reserve	Translation reserve	Retained earnings	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
At 1 January 2001	43,043	(41,252)	—	—	(7)	31,561	33,345
Currency translation difference	—	—	—	—	(2)	—	(2)
Net profit for the year	—	—	—	—	—	2,768	2,768
2000 final dividend paid	—	—	—	—	—	(40)	(40)
2000 other final dividends paid	—	—	—	—	—	(502)	(502)
Remittance of profits by merging branches	—	—	—	—	—	(3,034)	(3,034)
Capital contribution from ultimate holding company	—	—	—	—	—	8,068	8,068
Revaluation of properties	—	—	8,408	3,159	—	—	11,567
Capitalisation of reserves	—	41,252	(7,952)	(3,119)	—	(30,181)	—
At 31 December 2001	<u>43,043</u>	<u>—</u>	<u>456</u>	<u>40</u>	<u>(9)</u>	<u>8,640</u>	<u>52,170</u>
Bank and subsidiaries	43,043	—	456	40	(9)	8,591	52,121
Associates	—	—	—	—	—	49	49
	<u>43,043</u>	<u>—</u>	<u>456</u>	<u>40</u>	<u>(9)</u>	<u>8,640</u>	<u>52,170</u>
At 1 January 2002	43,043	—	456	40	(9)	8,640	52,170
Net profit for the year	—	—	—	—	—	6,711	6,711
2002 interim dividends	—	—	—	—	—	(4,520)	(4,520)
Reclassification	—	—	5	(5)	—	—	—
Revaluation of properties	—	—	31	(35)	—	—	(4)
Transfer on disposal of properties	—	—	(79)	—	—	79	—
At 31 December 2002	<u>43,043</u>	<u>—</u>	<u>413</u>	<u>—</u>	<u>(9)</u>	<u>10,910</u>	<u>54,357</u>
Bank and subsidiaries	43,043	—	413	—	(9)	10,918	54,365
Associates	—	—	—	—	—	(8)	(8)
	<u>43,043</u>	<u>—</u>	<u>413</u>	<u>—</u>	<u>(9)</u>	<u>10,910</u>	<u>54,357</u>

Statement of Changes in Equity

For the year ended 31 December

	Share capital	Premises revaluation reserve	Investment properties revaluation reserve	Retained earnings	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
At 1 January 2001	43,043	—	—	9,047	52,090
Reserves of merging branches and Hua Chiao Commercial Limited	—	—	—	9,179	9,179
Net profit for the year	—	—	—	1,332	1,332
2000 final dividend paid	—	—	—	(40)	(40)
Remittance of profits by merging branches	—	—	—	(3,034)	(3,034)
Capital contribution from ultimate holding company	—	—	—	8,068	8,068
Revaluation of properties	—	6,661	2,736	—	9,397
Capitalisation of reserves	—	(6,278)	(2,713)	(16,752)	(25,743)
At 31 December 2001	<u>43,043</u>	<u>383</u>	<u>23</u>	<u>7,800</u>	<u>51,249</u>
At 1 January 2002	43,043	383	23	7,800	51,249
Net profit for the year	—	—	—	6,176	6,176
2002 Interim dividends	—	—	—	(4,520)	(4,520)
Revaluation of properties	—	14	(23)	—	(9)
Transfer on disposal of properties	—	(71)	—	71	—
At 31 December 2002	<u>43,043</u>	<u>326</u>	<u>—</u>	<u>9,527</u>	<u>52,896</u>

Consolidated Cash Flow Statement

For the year ended 31 December

	Note	2002	2001
		HK\$'m	HK\$'m
Cash flow from operating activities			
Operating cash outflow before taxation	33(a)	(37,891)	(54,225)
Disposal of loans to Bank of China Grand Cayman Branch ("BOC Cayman")	40(a)	8,722	—
Hong Kong profits tax paid		(397)	(1,322)
Overseas profits tax paid		(20)	(23)
Net cash outflow from operating activities		(29,586)	(55,570)
Cash flow from investing activities			
Purchase of fixed assets		(434)	(1,448)
Proceeds from disposal of fixed assets		553	313
Purchase of investment securities		—	(30)
Proceeds from disposal of investment securities		—	271
Acquisition of subsidiaries	33(d)	(890)	24
Proceeds from disposal of subsidiaries		—	252
Proceeds from disposal of associates		—	394
Dividends received from associates		50	—
Distributions upon liquidation of subsidiary		—	(8)
Loans to associates		(336)	—
Loans repaid by associates		60	—
Net cash outflow from investing activities		(997)	(232)
Cash flow from financing activities			
Remittance of profit by merging branches		—	(3,034)
Certificates of deposit redeemed	33(b)	(5,000)	(4,000)
Dividends paid on ordinary shares		(1,937)	(542)
Dividends paid to minority shareholders		(79)	(638)
Net cash outflow from financing activities		(7,016)	(8,214)
Decrease in cash and cash equivalents		(37,599)	(64,016)
Cash and cash equivalents at 1 January		120,664	184,680
Cash and cash equivalents at 31 December	33(c)	83,065	120,664

Notes to the Accounts

(1) Principal activities

The Group is principally engaged in the provision of banking and related financial services in Hong Kong.

(2) Basis of preparation

The accounts have been prepared under the historical cost convention as modified by the revaluation of certain investments in securities, off-balance sheet instruments, premises and investment properties, and in accordance with accounting principles generally accepted in Hong Kong and comply with the Statements of Standard Accounting Practice (“SSAPs”) issued by the Hong Kong Society of Accountants (“HKSA”). In addition, these accounts comply fully with the requirements set out in the guideline on “Financial Disclosure by Locally Incorporated Authorized Institutions” under the Supervisory Policy Manual issued by the HKMA.

Pursuant to the Group Reorganisation on 1 October 2001, accomplished by the Bank of China (Hong Kong) Limited (Merger) Ordinance and the Merger Agreements, the Bank took over certain equity interests and assets, liabilities and business undertakings of certain entities under the common control of Bank of China (“BOC”), the ultimate holding company of the Bank (the “Restructuring and Merger”). Under the principles of merger accounting prescribed in the SSAP 27, “Accounting for Group Reconstructions”, the accounts of the Group are prepared as if the group structure and capital structure as at 1 October 2001 had been in existence from the beginning of the period presented.

The accounting policies and methods of computation used in the preparation of the accounts are consistent with those used in the preparation of the Group’s accounts for the year ended 31 December 2001. In the current year, the Group adopted the following SSAPs issued by the HKSA which are effective for accounting periods commencing on or after 1 January 2002:

- SSAP 1 (revised) : Presentation of financial statements
- SSAP 11 (revised) : Foreign currency translation
- SSAP 15 (revised) : Cash flow statements
- SSAP 34 (revised) : Employee benefits

The adoption of these SSAPs has not had any significant impact on the accounts.

Notes to the Accounts (continued)

(3) Principal accounting policies

(a) Basis of consolidation

The consolidated accounts include the accounts of the Bank and its subsidiaries made up to 31 December. Subsidiaries are those entities in which the Group, directly and indirectly, controls the composition of the board of directors, controls more than half of the voting power or holds more than half of the issued share capital. The results of subsidiaries acquired or disposed of during the year are included in the consolidated profit and loss account from the effective date of acquisition or up to the effective date of disposal, as appropriate.

All significant intercompany transactions and balances within the Group are eliminated on consolidation.

The gain or loss on the disposal of a subsidiary represents the difference between: a) the proceeds of the sale and, b) the Group's share of its net assets together with any unamortised goodwill (or goodwill taken to reserves and which was not previously charged or recognised in the consolidated profit and loss account) and any related accumulated foreign currency translation difference.

Minority interests represent the interests of outside shareholders in the operating results and net assets of subsidiaries.

In the Bank's balance sheet, the investments in subsidiaries are stated at cost less provision for impairment losses. The results of subsidiaries are accounted for by the Bank on the basis of dividends received and receivable.

(b) Associates

An associate is a company, not being a subsidiary, in which an equity interest is held for the long term and significant influence is exercised in its management.

The consolidated profit and loss account includes the Group's share of the results of associates for the year. The consolidated balance sheet includes the Group's share of the net assets of the associates plus goodwill/negative goodwill (net of accumulated amortisation) on acquisition and net of any provision for impairment losses.

In the Bank's balance sheet the investments in associates are stated at cost less provision for impairment in value. The results of associates are accounted for by the Bank on the basis of dividends received and receivable.

Unless the Group has incurred obligations or guaranteed obligations in respect of the associate, its share of further losses is discontinued when the share of losses of an associate equals or exceeds the carrying value of the investment in the associate.

Notes to the Accounts (continued)

(3) Principal accounting policies (continued)

(c) Revenue recognition

Interest income is recognised in the profit and loss account as it accrues, except in the case of doubtful debts, where interest is credited to a suspense account which is netted in the balance sheet against the relevant balances.

Fees and commission income are recognised in the period when earned unless they relate to transactions involving an interest rate risk or other risks which extend beyond the current period, in which case they are amortised over the period of the transaction.

Dividend income is recognised when the right to receive payment is established.

Rental income under operating leases is recognised on a straight-line basis over the period of the lease unless another systematic basis is more representative of the pattern in which the benefit derived from the leased asset is used.

(d) Advances

Advances to customers, banks and other financial institutions are reported on the balance sheet at the principal amount outstanding net of provisions for bad and doubtful debts and suspended interest. Advances to banks and other financial institutions include placements with banks and other financial institutions of more than one year.

All advances are recognised when cash is advanced to the borrowers.

Assets acquired by repossession of collateral for realisation would continue to be reported as advances, except in the case of a loan restructuring where the assets acquired is part of the terms of a new loan agreement and the assets are recognised on the balance sheet under the relevant assets category. When the repossessed asset is realised, the sales proceeds are applied against the outstanding advance and any shortfall is written off to the profit and loss account.

Notes to the Accounts (continued)

(3) Principal accounting policies (continued)

(e) Provisions for bad and doubtful debts

The Group internally classifies loans and advances into categories reflecting the Group's assessment of the borrower's capacity to repay and on the degree of doubt about the collectibility of interest and / or principal.

Provisions are made against specific loans and advances as and when the directors have doubt on the ultimate recoverability of principal or interest in full. Based on the directors' assessment of the potential losses on those identified loans and advances on a case-by-case basis, specific provision is made to reduce the carrying value of the assets, taking into account available collateral to their expected net realisable value. Where it is not possible to reliably estimate the loss, the Group applies pre-determined provisioning levels to the unsecured portion of loans and advances based on the Group's loan classification procedures.

In addition, amounts have been set aside as a general provision for bad and doubtful debts. Specific and general provisions are deducted from "Advances and other accounts" and "Other assets" in the balance sheet.

When there is no realistic prospect of recovery, the outstanding debt is written off.

(f) Fixed assets

(i) Premises

Premises are stated at cost or valuation less accumulated impairment losses and accumulated depreciation calculated to write off the assets over their estimated useful lives on a straight-line basis as follows:

Leasehold land Over the remaining period of lease

Buildings Over the shorter of the remaining period of the lease and 15 to 50 years

Notes to the Accounts (continued)

(3) Principal accounting policies (continued)

(f) Fixed assets (continued)

(i) Premises (continued)

Independent valuations were performed every five years prior to 2002 on individual properties on the basis of open market values. In the current year, the directors have assessed that the period between independent valuations should be changed from five years to three years. This change has no impact on the accounts of the Group. In the intervening years, the directors review the carrying value of individual properties and adjustment is made when they consider that there has been a material change. Increases in valuation are credited to the premises revaluation reserve. Decreases in valuation are first set off against increases on earlier valuations in respect of the same individual asset and thereafter are debited to the profit and loss account. Any subsequent increases are credited to the profit and loss account up to the amount previously debited, and then to the revaluation reserve. Upon disposal of premises, the relevant portion of the revaluation reserve realised in respect of previous valuations is released and transferred from the revaluation reserve to retained earnings.

The gain or loss on disposal of premises is the difference between the net sales proceeds and the carrying value of the relevant asset, and is recognised in the profit and loss account.

(ii) Investment properties

Investment properties are interests in land and buildings in respect of which construction work and development have been completed and which are held for their investment potential, any rental income being negotiated at arm's length.

Investment properties are valued annually and independent valuations are performed at intervals of not more than three years; in each of the intervening years, valuations are undertaken by professionally qualified persons appointed by the Group. The valuations are on an open market value basis. Changes in the value of investment properties are treated as movements in the investment properties revaluation reserve, unless the total of the reserve is insufficient to cover a deficit on a portfolio basis. In such cases, the amount by which the deficit exceeds the total amount in the investment properties revaluation reserve is charged to the profit and loss account. Where a deficit has previously been charged to the profit and loss account and a revaluation surplus subsequently arises, this surplus is credited to the profit and loss account to the extent of the deficit previously charged.

Notes to the Accounts (continued)

(3) Principal accounting policies (continued)

(f) Fixed assets (continued)

(ii) Investment properties (continued)

Investment properties held on leases with unexpired periods of 20 years or less are depreciated over the remaining terms of the leases.

Upon the disposal of an investment property, the relevant portion of the revaluation reserve realised in respect of previous valuations is released from the investment properties revaluation reserve to the profit and loss account.

(iii) Property under development

Property under development is carried at cost less impairment losses. Cost includes development and construction expenditure incurred, interest and other direct costs attributable to the development. On completion, the property is transferred to premises or investment properties.

(iv) Equipment, fixtures and fittings

Equipment, fixtures and fittings are stated at cost less accumulated impairment losses and accumulated depreciation calculated on a straight-line basis to write off the assets over their estimated useful lives, which are generally between 3 and 15 years.

The gain or loss on disposal of equipment, fixtures and fittings is recognised in the profit and loss account.

(v) Impairment and gain or loss on sale

At each balance sheet date, both internal and external sources of information are considered to determine whether there is any indication that premises, equipment, fixtures and fittings are impaired. If any such indication exists, the recoverable amount of the asset is estimated and where relevant, an impairment loss is recognised to reduce the asset to its recoverable amount. Such impairment losses are recognised in the profit and loss account except where the asset is carried at valuation and the impairment loss does not exceed the revaluation surplus for that same asset, in which case it is treated as a revaluation decrease.

The gain or loss on disposal of fixed assets is the difference between the net sales proceeds and the carrying value of the relevant assets, and is recognised in the profit and loss account.

Notes to the Accounts (continued)

(25) Fixed assets

	The Group				
	Premises	Investment properties	Property under development	Equipment, fixtures and fittings	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Cost or valuation					
At 1 January 2002	15,539	4,881	39	3,418	23,877
Additions	1	2	—	431	434
Acquisitions of subsidiaries	597	315	—	5	917
Disposals	(699)	(36)	—	(330)	(1,065)
Revaluation	(1,211)	(219)	—	—	(1,430)
Reclassification	(782)	782	—	—	—
At 31 December 2002	<u>13,445</u>	<u>5,725</u>	<u>39</u>	<u>3,524</u>	<u>22,733</u>
Accumulated depreciation					
At 1 January 2002	214	—	7	2,607	2,828
Depreciation for the year	401	—	—	231	632
Acquisitions of subsidiaries	—	—	—	4	4
Disposals	(127)	—	—	(330)	(457)
Write-back on revaluation	(486)	—	—	—	(486)
At 31 December 2002	<u>2</u>	<u>—</u>	<u>7</u>	<u>2,512</u>	<u>2,521</u>
Net book value					
At 31 December 2002	<u>13,443</u>	<u>5,725</u>	<u>32</u>	<u>1,012</u>	<u>20,212</u>
At 31 December 2001	<u>15,325</u>	<u>4,881</u>	<u>32</u>	<u>811</u>	<u>21,049</u>

The analysis of cost or revaluation of the above assets is as follows:

At 31 December 2002					
At cost	—	—	39	3,524	3,563
At valuation	13,445	5,725	—	—	19,170
	<u>13,445</u>	<u>5,725</u>	<u>39</u>	<u>3,524</u>	<u>22,733</u>
At 31 December 2001					
At cost	—	—	39	3,418	3,457
At valuation	15,539	4,881	—	—	20,420
	<u>15,539</u>	<u>4,881</u>	<u>39</u>	<u>3,418</u>	<u>23,877</u>

Notes to the Accounts (continued)

(25) Fixed assets (continued)

	The Bank				
	Premises	Investment properties	Property under development	Equipment, fixtures and fittings	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Cost or valuation					
At 1 January 2002	12,231	3,994	—	2,908	19,133
Additions	1	—	—	359	360
Transfer from a subsidiary	—	250	—	—	250
Disposals	(649)	(32)	—	(244)	(925)
Revaluation	(901)	(127)	—	—	(1,028)
Reclassification	(710)	710	—	—	—
At 31 December 2002	9,972	4,795	—	3,023	17,790
Accumulated depreciation					
At 1 January 2002	176	—	—	2,229	2,405
Depreciation for the year	314	—	—	174	488
Disposals	(176)	—	—	(244)	(420)
Write-back on revaluation	(314)	—	—	—	(314)
At 31 December 2002	—	—	—	2,159	2,159
Net book value					
At 31 December 2002	9,972	4,795	—	864	15,631
At 31 December 2001	12,055	3,994	—	679	16,728

The analysis of cost or revaluation of the above assets is as follows:

At 31 December 2002					
At cost	—	—	—	3,023	3,023
At valuation	9,972	4,795	—	—	14,767
	9,972	4,795	—	3,023	17,790
At 31 December 2001					
At cost	1,386	—	—	2,908	4,294
At valuation	10,845	3,994	—	—	14,839
	12,231	3,994	—	2,908	19,133

Notes to the Accounts (continued)

(25) Fixed assets (continued)

The carrying value of premises is analysed based on the remaining terms of the leases as follows:

	The Group		The Bank	
	2002	2001	2002	2001
	HK\$m	HK\$m	HK\$m	HK\$m
Held in Hong Kong				
On long term lease (over 50 years)	8,217	10,394	5,986	7,752
On medium term lease (10-50 years)	4,942	4,616	3,862	4,178
On short term lease (less than 10 years)	3	3	3	3
Held outside Hong Kong				
On long term lease (over 50 years)	53	94	15	14
On medium term lease (10-50 years)	222	217	106	108
On short term lease (less than 10 years)	6	1	—	—
	<u>13,443</u>	<u>15,325</u>	<u>9,972</u>	<u>12,055</u>

The carrying value of investment properties is analysed based on the remaining terms of the leases as follows:

	The Group		The Bank	
	2002	2001	2002	2001
	HK\$m	HK\$m	HK\$m	HK\$m
Held in Hong Kong				
On long term lease (over 50 years)	4,666	4,038	4,051	3,225
On medium term lease (10-50 years)	929	690	642	659
Held outside Hong Kong				
On long term lease (over 50 years)	37	5	22	—
On medium term lease (10-50 years)	93	148	80	110
	<u>5,725</u>	<u>4,881</u>	<u>4,795</u>	<u>3,994</u>

Investment properties were revalued at 31 December 2002 on the basis of their open market value by an independent firm of chartered surveyors, Chesterton Petty Limited.

As at 31 December 2002, the premises are included in the balance sheet at directors' valuation, having regard to the independent professional valuations carried out on majority of the premises.

Notes to the Accounts (continued)

(25) Fixed assets (continued)

As a result of the above-mentioned revaluation, increases and decreases in value of the Group's and the Bank's premises and investment properties were recognised in the Group's and the Bank's property revaluation reserves and the profit and loss account respectively as follows:

	The Group		The Bank	
	Premises	Investment properties	Premises	Investment properties
	HK\$m	HK\$m	HK\$m	HK\$m
Increase /(Decrease) in valuation credited / (debited) to property revaluation reserves	31	(35)	14	(23)
Decrease in valuation charged to profit and loss account	(756)	(184)	(601)	(104)
	<u>(725)</u>	<u>(219)</u>	<u>(587)</u>	<u>(127)</u>

As at 31 December 2002, the net book value of premises that would have been included in the Group's and the Bank's balance sheets had the assets been carried at cost less accumulated depreciation and impairment losses were HK\$7,448 million (2001: HK\$7,924 million) and HK\$5,515 million (2001: HK\$6,319 million) respectively.

(26) Hong Kong SAR currency notes in circulation

The Hong Kong SAR currency notes in circulation are secured by deposit of funds in respect of which Hong Kong SAR Government certificates of indebtedness are held.

(27) Deposits from customers

	The Group		The Bank	
	2002	2001	2002	2001
	HK\$m	HK\$m	HK\$m	HK\$m
Demand deposits and current accounts	21,476	18,639	17,938	15,888
Savings deposits	204,363	184,288	173,158	155,409
Time, call and notice deposits	375,138	403,501	313,246	340,210
	<u>600,977</u>	<u>606,428</u>	<u>504,342</u>	<u>511,507</u>

Notes to the Accounts (continued)

(28) Assets pledged as security

	The Group and the Bank	
	2002	2001
	HK\$m	HK\$m
Secured liabilities	3,198	1,813
Assets pledged as security		
- securities pledged as collateral	3,400	1,883

Secured liabilities and assets pledged as security relate to short positions in Exchange Fund Bills and Notes ("EFBNs") which are collateralised by long positions in EFBNs.

(29) Other accounts and provisions

	The Group		The Bank	
	2002	2001	2002	2001
	HK\$m	HK\$m	HK\$m	HK\$m
Interest payable	1,167	1,615	1,007	1,400
Current taxation (note a)	544	59	454	—
Deferred taxation	11	8	—	—
Restructuring provision (note b)	649	666	649	666
Dividend payable	2,583	—	2,583	—
Accruals and other payables	15,029	18,323	12,681	15,219
	19,983	20,671	17,374	17,285

(a) Current taxation

	The Group		The Bank	
	2002	2001	2002	2001
	HK\$m	HK\$m	HK\$m	HK\$m
Hong Kong profits tax	531	42	451	—
Overseas taxation	13	17	3	—
	544	59	454	—

Notes to the Accounts (continued)

(29) Other accounts and provisions (continued)

(b) Restructuring provision

	The Group and the Bank	
	2002	2001
	HK\$m	HK\$m
At 1 January	666	—
Charge to profit and loss account	—	937
Utilised during the year	(17)	(271)
At 31 December	<u>649</u>	<u>666</u>

The restructuring provision was made in relation to the Restructuring and Merger of the Group. The amounts not being utilised at 31 December 2002 mainly represents the stamp duty payable which arose from restructuring activities of the Group.

(30) Deferred taxation

The deferred tax liability mainly represents the taxation effect of accelerated depreciation allowances. The potential deferred tax asset arising from the general provision for bad and doubtful debts amounted to HK\$1,018 million and HK\$744 million as at 31 December 2002 (2001: HK\$1,046 million and HK\$749 million) has not been recognised in the Group's and the Bank's balance sheets.

(31) Share capital

	2002	2001
	HK\$m	HK\$m
Authorised:		
100,000,000,000 ordinary shares of HK\$1.00 each	<u>100,000</u>	<u>100,000</u>
Issued and fully paid:		
43,042,840,858 ordinary shares of HK\$1.00 each	<u>43,043</u>	<u>43,043</u>

Notes to the Accounts (continued)

(32) Reserves

	The Group		The Bank	
	2002	2001	2002	2001
	HK\$m	HK\$m	HK\$m	HK\$m
Premises revaluation reserve	413	456	326	383
Investment properties revaluation reserve	—	40	—	23
Translation reserve	(9)	(9)	—	—
Retained earnings	10,910	8,640	9,527	7,800
	<u>11,314</u>	<u>9,127</u>	<u>9,853</u>	<u>8,206</u>

(33) Notes to consolidated cash flow statement

(a) Reconciliation of operating profit after provisions to operating cash outflow before taxation:

	2002	2001
	HK\$m	HK\$m
Operating profit after provisions	9,235	5,750
Depreciation	632	460
Charge for bad and doubtful debts	2,855	7,412
Advances written off net of recoveries	(2,325)	(9,905)
Change in money at call and short notice with original maturity over three months	11,620	(9,507)
Change in treasury bills with original maturity over three months	9,904	(12,464)
Change in placements with banks and other financial institutions with original maturity over three months	3,494	(10,212)
Change in trade bills	(210)	157
Change in certificates of deposit held with original maturity over three months	989	331
Change in held-to-maturity securities	(43,243)	(2,639)
Change in other investments in securities	(8,191)	(22,288)
Change in advances and other accounts	(9,524)	19,914
Change in other assets	1,348	824
Change in deposits and balances of banks and other financial institutions repayable over three months	(5,204)	(13,801)
Change in deposits from customers	(5,451)	(18,298)
Change in other accounts and provisions	(3,820)	10,045
Exchange differences	—	(4)
Operating cash outflow before taxation	<u>(37,891)</u>	<u>(54,225)</u>

Notes to the Accounts (continued)

(33) Notes to consolidated cash flow statement (continued)

(b) Analysis of changes in financing

	2002		
	Share capital	Certificates of deposit issued	Minority interests
	HK\$m	HK\$m	HK\$m
At 1 January 2002	43,043	5,000	1,066
Cash outflow upon redemption	—	(5,000)	—
Minority interests share of profits	—	—	127
Dividends paid to minority shareholders	—	—	(79)
	<u>43,043</u>	<u>—</u>	<u>1,114</u>
	2001		
	Share capital	Certificates of deposit issued	Minority interests
	HK\$m	HK\$m	HK\$m
At 1 January 2001	43,043	9,000	1,532
Cash outflow upon redemption	—	(4,000)	—
Minority interests share of profits	—	—	133
Minority interests share of revaluation reserve	—	—	49
Dividends paid to minority shareholders	—	—	(638)
Released on disposal of subsidiaries	—	—	(10)
	<u>43,043</u>	<u>5,000</u>	<u>1,066</u>

Notes to the Accounts (continued)

(33) Notes to consolidated cash flow statement (continued)

(c) Analysis of the balances of cash and cash equivalents

	2002	2001
	HK\$m	HK\$m
Cash and balances with banks and other financial institutions	5,007	59,898
Money at call and short notice with original maturity		
within three months	77,354	87,183
Treasury bills with original maturity within three months	8,258	3,194
Placements with banks and other financial institutions		
with original maturity within three months	19,723	16,843
Certificates of deposit held with original maturity		
within three months	234	1,191
Deposits and balances of banks and other financial institutions		
with original maturity within three months	(27,511)	(47,645)
	<u>83,065</u>	<u>120,664</u>

(d) Acquisition of subsidiaries

	2002	2001
	HK\$m	HK\$m
Net assets acquired:		
- Fixed assets	913	13
- Other assets	41	—
- Cash and bank balances	124	61
- Other accounts and provisions	(64)	(37)
	<u>1,014</u>	<u>37</u>
Satisfied by:		
- Cash consideration	<u>1,014</u>	<u>37</u>
Analysis of net (outflow)/ inflow of cash and cash equivalents		
in respect of the acquisition of subsidiaries		
- Cash consideration	(1,014)	(37)
- Cash and bank balances	124	61
	<u>(890)</u>	<u>24</u>

Notes to the Accounts (continued)

(33) Notes to consolidated cash flow statement (continued)

(e) Significant non-cash transaction

As at 31 December 2002, the Group no longer exercised significant influence on Hong Kong Note Printing Limited amounted to HK\$31 million as at 31 December 2001 and such amount has therefore been reclassified from investments in associates to investment securities.

(34) Maturity profile

The maturity profile of assets and liabilities analysed by the remaining period as at 31 December to the contractual maturity dates are as follows:

	The Group						
	2002						
	Repayable on demand	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	Undated	Total
HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Assets							
Treasury bills	—	12,567	1,504	—	—	—	14,071
Cash and other short-term funds	5,007	95,997	—	—	—	—	101,004
Placements with banks and other financial institutions	21	72,411	7,727	—	—	—	80,159
Certificates of deposit held	—	1,921	6,589	8,824	194	—	17,528
Debt securities included in:							
- held-to-maturity securities	—	11,565	12,798	65,763	4,064	78	94,268
- other investments in securities	—	15,919	6,068	39,178	3,044	—	64,209
Advances to customers	26,979	17,172	25,702	124,813	100,533	25,835	321,034
Advances to banks and other financial institutions	—	1	1	303	—	—	305
Liabilities							
Deposits and balances of banks and other financial institutions	4,164	25,403	390	—	—	—	29,957
Deposits from customers	228,103	350,232	22,215	427	—	—	600,977

Notes to the Accounts (continued)

(34) Maturity profile (continued)

	The Bank						Total
	2002						
	Repayable on demand	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	Undated	
HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	
Assets							
Treasury bills	—	11,572	1,454	—	—	—	13,026
Cash and other short-term funds	3,999	73,732	—	—	—	—	77,731
Placements with banks and other financial institutions	20	54,391	5,918	—	—	—	60,329
Certificates of deposit held	—	1,783	5,901	8,021	194	—	15,899
Debt securities included in:							
- held-to-maturity securities	—	5,887	5,414	60,305	2,395	78	74,079
- other investments in securities	—	15,919	6,067	39,158	3,044	—	64,188
Advances to customers	22,139	13,729	22,100	108,149	84,489	23,624	274,230
Advances to banks and other financial institutions	—	1	1	303	—	—	305
Liabilities							
Deposits and balances of banks and other financial institutions	3,758	26,257	174	—	—	—	30,189
Deposits from customers	193,027	292,505	18,476	334	—	—	504,342

Notes to the Accounts (continued)

(34) Maturity profile (continued)

	The Group						Total
	2001						
	Repayable on demand	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	Undated	
HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	
Assets							
Treasury bills	—	12,721	6,190	—	—	—	18,911
Cash and other short-term funds	59,898	117,446	—	—	—	—	177,344
Placements with banks and other financial institutions	—	53,700	27,073	—	—	—	80,773
Certificates of deposit held	—	4,768	6,768	7,789	149	—	19,474
Debt securities included in:							
- held-to-maturity securities	2	8,641	12,853	24,675	4,859	—	51,030
- other investments in securities	—	27,021	5,885	22,130	1,043	—	56,079
Advances to customers	29,161	19,787	22,809	111,542	103,796	35,943	323,038
Advances to banks and other financial institutions	—	—	—	4	—	—	4
Liabilities							
Deposits and balances of banks and other financial institutions	5,154	48,477	1,664	—	—	—	55,295
Deposits from customers	205,835	367,024	32,473	1,096	—	—	606,428
Certificates of deposit issued	—	—	5,000	—	—	—	5,000

Notes to the Accounts (continued)

(34) Maturity profile (continued)

	The Bank						
	2001						
	Repayable on demand	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	Undated	Total
HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	
Assets							
Treasury bills	—	11,968	6,151	—	—	—	18,119
Cash and other short-term funds	50,925	99,668	—	—	—	—	150,593
Placements with banks and other financial institutions	—	38,876	22,771	—	—	—	61,647
Certificates of deposit held	—	4,501	6,140	7,272	149	—	18,062
Debt securities included in:							
- held-to-maturity securities	2	2,741	4,260	21,456	4,258	—	32,717
- other investments in securities	—	27,021	5,885	21,960	1,043	—	55,909
Advances to customers	26,344	17,764	19,708	93,514	86,310	33,235	276,875
Advances to banks and other financial institutions	—	—	—	4	—	—	4
Liabilities							
Deposits and balances of banks and other financial institutions	4,576	47,325	1,529	—	—	—	53,430
Deposits from customers	174,109	311,611	24,848	939	—	—	511,507
Certificates of deposit issued	—	—	5,000	—	—	—	5,000

Notes to the Accounts (continued)

(34) Maturity profile (continued)

The above maturity classifications have been prepared in accordance with the guideline on “Financial Disclosure by Locally Incorporated Authorized Institutions” under the Supervisory Policy Manual issued by the HKMA. In accordance with the guideline, the Group has reported assets such as advances and debt securities which have been overdue for not more than one month as “Repayable on demand” and assets which are non-performing or which are overdue for more than one month as “Undated”. In the case of an asset which is repayable by different payments or instalments, only that portion of the asset which is actually overdue is reported as overdue. Any part of the asset which is not due is reported according to the residual maturity unless the repayment of the asset is in doubt in which case the amount is reported as “Undated”. The above assets are stated before deduction of provisions, if any.

The analysis of other investments in securities by remaining period to maturity is disclosed in order to comply with the guideline on “Financial Disclosure by Locally Incorporated Authorized Institutions” under the Supervisory Policy Manual issued by the HKMA. The disclosure does not imply that the securities will be held to maturity.

(35) Off-balance sheet exposures

(a) Contingent liabilities and commitments

The following is a summary of the contractual amounts of each significant class of contingent liabilities and commitments:

	The Group		The Bank	
	2002	2001	2002	2001
	HK\$m	HK\$m	HK\$m	HK\$m
Direct credit substitutes	3,839	1,967	3,493	1,598
Transaction-related contingencies	2,286	2,273	2,150	2,177
Trade-related contingencies	16,409	16,391	12,973	13,553
Other commitments with an original maturity of :				
- under 1 year or which are unconditionally cancellable	75,844	84,497	46,736	57,291
- 1 year and over	64,402	43,879	58,935	40,629
Others	—	88	—	88
	162,780	149,095	124,287	115,336

Notes to the Accounts (continued)

(35) Off-balance sheet exposures (continued)

(b) Derivatives

The following is a summary of the notional amounts of each significant type of derivative:

	The Group					
	2002			2001		
	Trading	Hedging	Total	Trading	Hedging	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Exchange rate contracts:						
Spot	13,697	—	13,697	18,766	—	18,766
Forward and futures contracts	224	—	224	3,224	—	3,224
Swaps	179,544	6,082	185,626	124,585	4,688	129,273
Foreign exchange option contracts:						
- Currency options purchased	622	—	622	2,195	—	2,195
- Currency options written	28,633	—	28,633	19,850	—	19,850
	<u>222,720</u>	<u>6,082</u>	<u>228,802</u>	<u>168,620</u>	<u>4,688</u>	<u>173,308</u>
Interest rate contracts:						
Interest rate swaps	228	20,055	20,283	60	10,088	10,148
Forward rate agreements	—	—	—	1,280	—	1,280
	<u>228</u>	<u>20,055</u>	<u>20,283</u>	<u>1,340</u>	<u>10,088</u>	<u>11,428</u>
Bullion contracts	<u>779</u>	<u>—</u>	<u>779</u>	<u>545</u>	<u>—</u>	<u>545</u>
Equity contracts:						
- Equity options purchased	975	—	975	—	—	—
- Equity options written	873	—	873	—	—	—
	<u>1,848</u>	<u>—</u>	<u>1,848</u>	<u>—</u>	<u>—</u>	<u>—</u>
Total	<u>225,575</u>	<u>26,137</u>	<u>251,712</u>	<u>170,505</u>	<u>14,776</u>	<u>185,281</u>

Notes to the Accounts (continued)

(35) Off-balance sheet exposures (continued)

(b) Derivatives (continued)

	The Bank					
	2002			2001		
	Trading	Hedging	Total	Trading	Hedging	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Exchange rate contracts:						
Spot	12,900	—	12,900	18,373	—	18,373
Forward and futures contracts	202	—	202	3,203	—	3,203
Swaps	178,344	5,797	184,141	123,586	4,426	128,012
Foreign exchange option contracts:						
- Currency options purchased	622	—	622	2,195	—	2,195
- Currency options written	28,633	—	28,633	19,850	—	19,850
	<u>220,701</u>	<u>5,797</u>	<u>226,498</u>	<u>167,207</u>	<u>4,426</u>	<u>171,633</u>
Interest rate contracts:						
Interest rate swaps	228	17,499	17,727	60	8,902	8,962
Forward rate agreements	—	—	—	1,280	—	1,280
	<u>228</u>	<u>17,499</u>	<u>17,727</u>	<u>1,340</u>	<u>8,902</u>	<u>10,242</u>
Bullion contracts	<u>779</u>	<u>—</u>	<u>779</u>	<u>545</u>	<u>—</u>	<u>545</u>
Equity contracts:						
- Equity options purchased	975	—	975	—	—	—
- Equity options written	873	—	873	—	—	—
	<u>1,848</u>	<u>—</u>	<u>1,848</u>	<u>—</u>	<u>—</u>	<u>—</u>
Total	<u>223,556</u>	<u>23,296</u>	<u>246,852</u>	<u>169,092</u>	<u>13,328</u>	<u>182,420</u>

Notes to the Accounts (continued)

(35) Off-balance sheet exposures (continued)

(b) Derivatives (continued)

The replacement costs and credit risk weighted amounts of the above off-balance sheet exposures which do not take into account the effects of bilateral netting arrangements are as follows:

	The Group			
	2002	2001	2002	2001
	Credit risk weighted amount		Replacement cost	
	HK\$m	HK\$m	HK\$m	HK\$m
Contingent liabilities and commitments	45,936	29,490	N/A	N/A
Derivatives:				
- Exchange rate contracts	596	407	870	457
- Interest rate contracts	60	37	120	99
- Bullion contracts	5	5	13	6
- Equity contracts	33	—	17	—
	694	449	1,020	562
Total	46,630	29,939	1,020	562
	The Bank			
	2002	2001	2002	2001
	Credit risk weighted amount		Replacement cost	
	HK\$m	HK\$m	HK\$m	HK\$m
Contingent liabilities and commitments	41,040	26,750	N/A	N/A
Derivatives:				
- Exchange rate contracts	590	393	866	427
- Interest rate contracts	47	25	96	53
- Bullion contracts	5	5	13	6
- Equity contracts	33	—	17	—
	675	423	992	486
Total	41,715	27,173	992	486

Notes to the Accounts (continued)

(35) Off-balance sheet exposures (continued)

(b) Derivatives (continued)

The contract or notional amounts of these instruments indicate the volume of transactions outstanding as at 31 December 2002 and 31 December 2001; they do not represent the amounts at risk.

The credit risk weighted amounts are the amounts which have been calculated in accordance with the Third Schedule of the Banking Ordinance and guidelines issued by the HKMA. The amounts calculated are dependent upon the status of the counterparty and the maturity characteristics of each type of contract.

Replacement cost is the cost of replacing all contracts which have a positive value when marked to market (should the counterparty default on its obligations) and is obtained by marking contracts to market. Replacement cost is a close approximation of the credit risk for these contracts at the balance sheet dates.

(36) Capital commitments

The Group and the Bank have the following outstanding capital commitments not provided for in the accounts:

	The Group and the Bank	
	2002	2001
	HK\$m	HK\$m
Authorised and contracted for but not recorded	303	74
Authorised and not contracted for	—	25
	<u>303</u>	<u>99</u>

The above capital commitments mainly relate to the purchases of computer equipment and software.

Notes to the Accounts (continued)

(37) Operating lease commitments

As lessee

The Group and the Bank have commitments to make the following future minimum lease payments under non-cancellable operating leases:

	The Group		The Bank	
	2002	2001	2002	2001
	HK\$m	HK\$m	HK\$m	HK\$m
Land and buildings				
- not later than one year	164	333	158	302
- later than one year but not later than five years	175	150	167	136
- later than five years	9	—	—	—
	<u>348</u>	<u>483</u>	<u>325</u>	<u>438</u>

As lessor

The Group and the Bank have contracted with tenants for the following future minimum lease receivables:

	The Group		The Bank	
	2002	2001	2002	2001
	HK\$m	HK\$m	HK\$m	HK\$m
Land and buildings				
- not later than one year	198	241	213	218
- later than one year but not later than five years	226	291	247	286
- later than five years	2	—	2	—
	<u>426</u>	<u>532</u>	<u>462</u>	<u>504</u>

Notes to the Accounts (continued)

(38) Litigation

The Group is currently being served a number of claims and counterclaims by various independent parties. These claims and counterclaims are in relation to the normal commercial activities of the Group.

No material provision was made against these claims and counterclaims because the directors believe the Group has meritorious defences against the claimants or the amounts involved in these claims are not expected to be material.

(39) Loans to directors and officers

Particulars of advances made to directors and officers of the Group pursuant to section 161B(4B) of the Hong Kong Companies Ordinance are as follows:

	2002	2001
	HK\$m	HK\$m
Aggregate amount of relevant loans outstanding at year end	<u>99</u>	<u>14</u>
Maximum aggregate amount of relevant loans outstanding during the year	<u>137</u>	<u>20</u>

Notes to the Accounts (continued)

(40) Significant related party transactions

Related parties are those parties which have the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence. Related parties may be individuals or other entities.

During the year, the Group entered into various transactions with related parties including the ultimate holding company, the associates of the Group and entities, directly or indirectly, controlled or significantly influenced by the ultimate holding company.

(a) Sale of certain assets to related parties

Sale of loans to BOC Cayman in 2002

Pursuant to a sale and purchase agreement entered into on 26 June 2002 between the Bank and BOC acting through its Grand Cayman branch, the Bank disposed of all of its beneficial interest in certain loans with a gross book value of HK\$11,401 million net of specific provisions of HK\$2,679 million for a consideration of HK\$8,722 million. Included in the loans disposed were loans granted to related parties with a gross book value of HK\$5,693 million and specific provisions of HK\$749 million. The consideration received in respect of these loans amounted to HK\$4,944 million. The gross and net book value of these loans included in the balance sheet as at 31 December 2001 amounted to HK\$5,418 million and HK\$4,635 million, respectively.

The sale and purchase agreement provides that the Bank sells and BOC acquires, on and from the transaction date, without recourse the beneficial interests of the Bank in the loans together with certain related security.

Sales of properties to Bank of China Group Insurance Company Limited ("BOC Insurance")

On 2 December 2002, the Bank entered into a sale and purchase agreement with BOC Insurance, an indirect owned subsidiary of BOC. Pursuant to the said agreement, the Bank agreed to sell and BOC Insurance agreed to purchase the property known as Sin Hua Bank Centre situated at 134-136 Des Voeux Road Central at a consideration of HK\$193 million. Following completion of the said disposal, the Bank will lease back part of the subject property from BOC Insurance at a monthly rental of HK\$400,000 per month (exclusive of rates and management fees) to continue with the operation of its Gilman Street Branch. Completion is expected to take place on or before 2 April 2003.

Notes to the Accounts (continued)

(40) Significant related party transactions (continued)

(a) Sale of certain assets to related parties (continued)

Service and administration of loans sold to related parties

Pursuant to servicing agreements entered into on 6 July 2002 between the Bank, Nanyang Commercial Bank, Limited (“Nanyang”), BOC and Zhong Gang (Cayman) Company Limited (“Zhong Gang”), the Bank and Nanyang undertake to service and administer the loans and the related securities which were transferred to Zhong Gang in 1999 and BOC Cayman in June 2002 at a fee to be agreed among the parties from time to time. In 2002, the relevant service fees amounted to approximately HK\$7 million.

(b) Purchase of certain assets from related parties

Acquisition of subsidiaries

During the year, the Bank acquired a 100% interest in two companies, namely Sin Chiao Enterprises Corporation Limited and Perento Limited from a fellow subsidiary, Kawell Investments Limited, at a total consideration of approximately HK\$1 billion. The primary business of the two companies is the holding of properties mainly used by the Bank as bank premises. The acquisition discharged certain inter-company debts due from a fellow subsidiary to the Bank. The transactions were conducted on normal commercial terms.

(c) Advances to third parties guaranteed by related parties

As at 31 December 2002, BOC and a fellow subsidiary provided guarantees for loans in favour of the Group amounted to HK\$1,982 million (2001: HK\$1,900 million) to certain third parties. The fellow subsidiary held equity interests of not more than 20% in these third parties.

Notes to the Accounts (continued)

(40) Significant related party transactions (continued)

(d) Summary of transactions entered into during the ordinary course of business with the related parties

The aggregate income and expenses arising from related party transactions with BOC, fellow subsidiaries, and associates are summarised as follows:

	Note	2002 HK\$'m	2001 HK\$'m
Profit and loss items:			
Interest income	(i)	491	4,349
Interest expense	(ii)	(247)	(2,795)
Insurance commission received (net)	(iii)	98	39
Administrative services fees received	(iv)	24	14
Rental and license fees received	(iv)	28	25
Funds selling commission received	(vi)	103	29
Correspondent banking fee sharing	(vii)	9	8
Credit card commission paid (net)	(v)	(47)	(21)
Securities brokerage commission paid (net)	(v)	(82)	(119)
Rental fees paid	(v)	(35)	(61)
Property management and letting agency fees paid	(v)	(18)	(13)
Charge for bad and doubtful debts		(15)	(403)
		<u> </u>	<u> </u>
	Note	2002 HK\$'m	2001 HK\$'m
Balance sheet items:			
Cash and short-term funds	(i)	15,041	69,458
Placements with banks and other financial institutions	(i)	17,539	13,400
Advances	(i), (viii)	867	6,531
Other investments in securities	(i)	234	234
Other assets	(ix)	15	106
Deposits from and balances of banks and other financial institutions	(ii)	20,304	48,386
Deposits from customers	(ii)	4,409	3,958
Other accounts and provisions	(ix)	15	—
		<u> </u>	<u> </u>

Notes to the Accounts (continued)

(40) Significant related party transactions (continued)

(d) Summary of transactions entered into during the ordinary course of business with the related parties (continued)

Notes:

(i) Interest income

In the ordinary course of business, the Group enters into various transactions with BOC, fellow subsidiaries and associates including deposit of cash and short-term funds, placement of interbank deposits, investments in its securities and provision of loans. The transactions were conducted in the normal course of business at prices and terms which are no more favourable than those charged to and contracted with other third party customers of the Group.

(ii) Interest expense

In the ordinary course of business, the Group accepts interbank deposits and current, fixed, savings and other deposits from BOC, fellow subsidiaries and associates on normal commercial terms with reference to prevailing market rates.

(iii) Insurance commission received (net)

In the ordinary course of business, the Group provides insurance agency services to and purchases general and life insurance policies from fellow subsidiaries on normal commercial terms with reference to prevailing market rates.

(iv) Administrative services fees, rental and license fees received

In the ordinary course of business, the Group provides various administrative services including internal audit, technology, human resources support and training to, and receives office premises rental and license fees from BOC, fellow subsidiaries and associates on normal commercial terms.

(v) Commission, property management, letting agency fee and rental fees paid

In the ordinary course of business, the Group pays commission fees for credit card administrative and promotional services, securities brokerage services, property management and letting agency fees to BOC and fellow subsidiaries. The Group also pays rental fees to BOC and its associates. These transactions have been entered into in the ordinary course of business and on normal commercial terms.

(vi) Funds selling commission received

In the ordinary course of business, the Group also engages in promoting and selling fund products of a fellow subsidiary to customers of the Group as their intermediary on normal commercial terms.

Notes to the Accounts (continued)

(40) Significant related party transactions (continued)

(d) Summary of transactions entered into during the ordinary course of business with the related parties (continued)

(vii) Correspondent banking fee sharing

In the ordinary course of business, the Group provides services to its customers include advising on and collecting letters of credit issued by BOC and remittances. BOC also provides similar services to its customers including advising on and collecting letters of credit issued by the Group and remittances. The Group shares the fees paid by customers of BOC and of the Group accordingly.

(viii) Advances to related parties

In the ordinary course of business, the Group extends loans and credit facilities to BOC, fellow subsidiaries, and associates on normal commercial terms with reference to prevailing market rates. The revenue from such transactions would include interest income on the amount drawn as well as arrangement and commitment fees.

(ix) Other assets and other accounts and provisions

Included within "Other assets" and "Other accounts and provisions" are receivables from and payables to BOC and fellow subsidiaries. The receivables and payables arose from transactions carried out in the normal course of business.

(e) Off-balance sheets items

Contingent liabilities and commitments

In the ordinary course of business, the Group provides guarantees for the obligations of BOC and fellow subsidiaries on normal commercial terms. Such guarantees as at 31 December 2002 amounted to HK\$185 million (2001: HK\$297 million).

Derivatives

In the ordinary course of business, the Group enters into foreign exchange contracts and interest rate contracts with BOC and fellow subsidiaries. The aggregate notional amount of such derivative transactions amounted to HK\$12,722 million as at 31 December 2002 (2001: HK\$10,655 million). These transactions are executed on normal commercial terms with reference to prevailing market rates.

Notes to the Accounts (continued)

(40) Significant related party transactions (continued)

(f) Balances with group companies and associates

Included in the following balance sheet captions are balances with the ultimate holding company:

	2002	2001
	HK\$m	HK\$m
Cash and short-term funds	15,031	69,197
Placements with banks and other financial institutions	17,533	13,053
Advances	4	37
Other investments in securities	234	234
Other assets	—	106
Deposits from and balances of banks and other financial institutions	19,107	48,004

Included in the following balance sheet captions are balances with fellow subsidiaries and associates of the ultimate holding company:

	2002	2001
	HK\$m	HK\$m
Cash and short-term funds	10	191
Placements with banks and other financial institutions	6	347
Advances	517	5,717
Other assets	15	—
Deposits from and balances of banks and other financial institutions	1,195	379
Deposits from customers	4,352	3,936
Other accounts and provisions	15	—

Notes to the Accounts (continued)

(40) Significant related party transactions (continued)

(f) Balances with group companies and associates (continued)

Included in the following balance sheet captions are balances with subsidiaries of the Bank:

	2002	2001
	HK\$m	HK\$m
Cash and short-term funds	1,281	1,564
Advances	950	956
Other assets	1,815	577
Deposits from and balances of banks and other financial institutions	1,817	618
Deposits from customers	894	964
Other accounts and provisions	1,567	2,120

There were no material balances with associates of the Group as at 31 December 2002.

(g) Key management personnel

Other than the advances to key management personnel of approximately HK\$99 million, no material transaction was conducted with key management personnel of the Bank and its holding companies and parties related to them.

(41) Ultimate holding company

The ultimate holding company is BOC, a state-owned commercial bank established under the laws of PRC.

(42) Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 20 March 2003.

Unaudited Supplementary Financial Information

(1) Capital adequacy

	<u>2002</u>	<u>2001</u>
Capital adequacy ratio	<u>13.99%</u>	<u>14.38%</u>
Adjusted capital adequacy ratio	<u>14.39%</u>	<u>14.57%</u>

The capital adequacy ratio ("CAR") is computed on the consolidated basis which comprises the positions of the Bank and certain subsidiaries specified by the HKMA for its regulatory purposes and in accordance with the Third Schedule of the Banking Ordinance.

The adjusted CAR taking into account market risk exposure as at the balance sheet date is computed in accordance with the guideline on "Maintenance of Adequate Capital Against Market Risks" under the Supervisory Policy Manual issued by the HKMA and on the same basis as for the unadjusted CAR.

Unaudited Supplementary Financial Information (continued)

(2) Components of capital base after deductions

The consolidated capital base after deductions used in the calculation of the above capital adequacy ratios as at 31 December 2002 and 31 December 2001 and reported to the HKMA is analysed as follows:

	2002	2001
	HK\$m	HK\$m
Core capital:		
Paid up ordinary share capital	43,043	43,043
Reserves	8,087	9,481
Profit and loss account	2,360	(850)
Minority interests	867	910
	<u>54,357</u>	<u>52,584</u>
Supplementary capital:		
General provisions for doubtful debts	5,200	4,943
	<u>59,557</u>	<u>57,527</u>
Total capital base before deductions		
Deductions:		
Shareholdings in subsidiaries or holding company	(482)	(375)
Exposures to connected companies	(918)	(347)
Equity investments of 20% or more in non-subsidiary companies	(171)	(256)
Investments in the capital of other banks or other financial institutions	(1)	(1)
	<u>(1,572)</u>	<u>(979)</u>
Total capital base after deductions	<u><u>57,985</u></u>	<u><u>56,548</u></u>

Unaudited Supplementary Financial Information (continued)

(3) Liquidity ratio

	2002	2001
Average liquidity ratio	41.17%	39.88%

The average liquidity ratio for the year ended 31 December 2002 is calculated as the simple average of each calendar month's average liquidity ratio of the Bank for the year.

The average liquidity ratio for 2001 is calculated as the simple average of each calendar month's average liquidity ratio of the Bank for the 3 months from 1 October 2001 (the date of the Restructuring and Merger) to 31 December 2001.

The liquidity ratio is computed on the solo basis (the Hong Kong offices only) and is in accordance with the Fourth Schedule of the Banking Ordinance.

Prior to the Restructuring and Merger, the liquidity ratio of each of the predecessor entities was managed on an individual basis.

(4) Currency concentrations

The following is a summary of the major foreign currency exposures arising from trading, non-trading and structural positions. The net option position is calculated based on the worst-case approach set out in the prudential return "Foreign Currency Position" issued by the HKMA.

	2002						Total
	Equivalent in millions of HK\$						
	US Dollars	Euro Dollars	Canadian Dollars	Australian Dollars	New Zealand Dollars	Others	
Spot assets	168,003	16,688	5,002	23,525	11,809	28,198	253,225
Spot liabilities	(135,565)	(10,753)	(6,352)	(27,799)	(15,226)	(20,381)	(216,076)
Forward purchases	102,549	7,025	1,964	8,798	5,381	32,696	158,413
Forward sales	(138,688)	(13,279)	(610)	(4,541)	(1,884)	(40,412)	(199,414)
Net options position	(444)	41	101	192	100	13	3
Net long/(short) position	(4,145)	(278)	105	175	180	114	(3,849)

Unaudited Supplementary Financial Information (continued)

(4) Currency concentrations (continued)

	2001						Total
	Equivalent in millions of HK\$						
	US Dollars	Euro Dollars	Canadian Dollars	Australian Dollars	New Zealand Dollars	Others	
Spot assets	197,497	13,689	6,269	28,316	14,167	21,579	281,517
Spot liabilities	(134,348)	(11,303)	(6,095)	(27,380)	(14,550)	(21,513)	(215,189)
Forward purchases	70,500	8,894	127	1,623	1,211	19,769	102,124
Forward sales	(124,606)	(11,313)	(301)	(2,538)	(794)	(19,616)	(159,168)
Net options position	4,277	75	(53)	135	43	7	4,484
Net long/(short) position	13,320	42	(53)	156	77	226	13,768

There were no significant net structural positions for the Group as at 31 December 2002 and 31 December 2001.

(5) Segmental information

(a) Segmental reporting

A segment is a distinguishable component of the Group that is engaged either in providing products and services (business segment), or in providing products and services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other business or geographical segments. The Group has chosen business segment information as the primary reporting format and geographical segment information as the secondary reporting format.

Segment revenue, expenses, results, assets and liabilities include items directly attributable to a segment and those that can be allocated on a reasonable basis to that segment. The allocation of revenue reflects the benefits of capital and other funding resources allocated to the business or geographical segments by way of internal capital allocations and fund transfer mechanisms.

Unaudited Supplementary Financial Information (continued)

(5) Segmental information (continued)

(a) Segmental reporting (continued)

(i) By class of business

	2002					
	Commercial banking	Treasury	Unallocated	Subtotal	Eliminations	Consolidated
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Net interest income	10,876	2,375	691	13,942	—	13,942
Other operating income	3,110	745	866	4,721	(544)	4,177
Operating income	13,986	3,120	1,557	18,663	(544)	18,119
Operating expenses	(4,504)	(174)	(1,895)	(6,573)	544	(6,029)
Operating profit/(loss) before provisions	9,482	2,946	(338)	12,090	—	12,090
Charge for bad and doubtful debts	(2,855)	—	—	(2,855)	—	(2,855)
Operating profit/(loss) after provisions	6,627	2,946	(338)	9,235	—	9,235
Net loss from disposal/ revaluation of fixed assets	—	—	(995)	(995)	—	(995)
Provision for impairment on held-to-maturity securities and investment securities	—	(4)	(3)	(7)	—	(7)
Provision for impairment on investments in associates	—	—	(27)	(27)	—	(27)
Share of operating losses of associates	—	—	(100)	(100)	—	(100)
Profit/(loss) before taxation	6,627	2,942	(1,463)	8,106	—	8,106
Assets						
Segment assets	313,429	400,100	21,182	734,711	—	734,711
Investments in associates	—	—	483	483	—	483
Unallocated corporate assets	—	—	304	304	—	304
	313,429	400,100	21,969	735,498	—	735,498
Liabilities						
Segment liabilities	612,240	62,431	2,469	677,140	—	677,140
Unallocated corporate liabilities	—	—	2,887	2,887	—	2,887
	612,240	62,431	5,356	680,027	—	680,027
Other Information						
Additions of fixed assets	—	—	1,351	1,351	—	1,351
Depreciation	—	—	632	632	—	632
Amortisation of premium/discount of held-to-maturity securities	—	1,089	—	1,089	—	1,089
Non-cash expenses other than depreciation/amortisation	2,855	—	—	2,855	—	2,855

Unaudited Supplementary Financial Information (continued)

(5) Segmental information (continued)

(a) Segmental reporting (continued)

(i) By class of business (continued)

	2001					
	Commercial banking	Treasury	Unallocated	Subtotal	Eliminations	Consolidated
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Net interest income	10,758	3,238	991	14,987	—	14,987
Other operating income	2,925	888	724	4,537	(515)	4,022
Operating income	13,683	4,126	1,715	19,524	(515)	19,009
Operating expenses	(4,811)	(335)	(1,216)	(6,362)	515	(5,847)
Operating profit before provisions	8,872	3,791	499	13,162	—	13,162
Charge for bad and doubtful debts	(7,412)	—	—	(7,412)	—	(7,412)
Operating profit after provisions	1,460	3,791	499	5,750	—	5,750
Restructuring costs	—	—	(937)	(937)	—	(937)
Net loss from disposal/ revaluation of fixed assets	—	—	(1,237)	(1,237)	—	(1,237)
Net gain from disposal of held-to-maturity securities and investment securities	—	—	20	20	—	20
Write-back of provision for impairment on held-to-maturity securities and investment securities	—	23	1	24	—	24
Net gain on disposal of subsidiaries	—	—	12	12	—	12
Provision for impairment on investments in associates/ gain on disposal of associates	—	—	20	20	—	20
Share of operating profits of associates	—	—	81	81	—	81
Profit/(loss) before taxation	1,460	3,814	(1,541)	3,733	—	3,733
Assets						
Segment assets	312,158	430,990	21,938	765,086	—	765,086
Investments in associates	—	—	416	416	—	416
Unallocated corporate assets	—	—	638	638	—	638
	312,158	430,990	22,992	766,140	—	766,140
Liabilities						
Segment liabilities	616,875	93,444	2,357	712,676	—	712,676
Unallocated corporate liabilities	—	—	228	228	—	228
	616,875	93,444	2,585	712,904	—	712,904
Other Information						
Additions of fixed assets	—	—	1,463	1,463	—	1,463
Depreciation	—	—	460	460	—	460
Amortisation of premium/discount of held-to-maturity securities	—	734	—	734	—	734
Non-cash expenses other than depreciation/amortisation	7,412	—	—	7,412	—	7,412

Unaudited Supplementary Financial Information (continued)

(5) Segmental information (continued)

(a) Segmental reporting (continued)

(i) By class of business (continued)

Commercial banking business includes acceptance of deposits, mortgage lending, credit card advances, remittance, provision of securities brokerage and insurance agency services, commercial lending, trade finance and overdraft facilities.

Treasury activities include money market, foreign exchange dealing and capital market activities. Treasury manages funding of the Group. Treasury provides funding to all other business segments and receives funds from commercial banking's deposit taking activities. These inter-segment funding transactions are priced either at market bid/offer rates as appropriate or at an internal funding rate as determined by the average funding requirements of other business segments and the average one-month inter-bank rates of the relevant financial year. In addition, the gains and losses on the foreign exchange activities of the Group are included under "Treasury". The profit and loss information presented in this note has been prepared using inter-segment charging/income transactions. The segmental assets and liabilities have not been adjusted to reflect the effect of inter-segment borrowing and lending (i.e. segmental profit and loss information is not comparable to segmental assets and liabilities information).

Unallocated items mainly comprise fixed assets of the Group, investment securities, investments in associates and other items which cannot be reasonably allocated to a specific business segment. The interest benefit of the capital of the Group is also included as unallocated within net interest income. Rental expenses are allocated to business segments based on a fixed rate per square footage occupied.

Operating expenses of a functional unit are allocated to the relevant business segment which is the predominant user of the services provided by the unit. Operating expenses of other shared services which cannot be allocated to a specific business segment are included under "Unallocated".

(ii) By geographical area

No geographical reporting is provided as over 90% of the Group's revenues are derived from Hong Kong and over 90% of the Group's assets are originated from business decisions and operations based in Hong Kong.

Unaudited Supplementary Financial Information (continued)

(5) Segmental information (continued)

(b) Sectoral analysis of gross advances to customers

The information concerning gross advances to customers has been analysed into loans used inside or outside Hong Kong by industry sectors of the borrowers as follows:

	2002	2001
	HK\$m	HK\$m
Loans for use in Hong Kong		
Industrial, commercial and financial		
- Property development	26,591	28,300
- Property investment	50,992	47,758
- Financial concerns	8,891	7,314
- Stockbrokers	82	108
- Wholesale and retail trade	23,781	24,091
- Manufacturing	12,834	11,477
- Transport and transport equipment	11,192	8,778
- Others	40,440	51,054
Individuals		
- Loans for the purchase of flats in Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	19,956	20,273
- Loans for purchase of other residential properties	85,853	82,513
- Credit card advances	3,554	3,019
- Others	8,469	9,735
Total loans for use in Hong Kong	292,635	294,420
Trade finance	8,873	10,566
Loans for use outside Hong Kong	19,526	18,052
Gross advances to customers	321,034	323,038

Unaudited Supplementary Financial Information (continued)

(5) Segmental information (continued)

(c) Geographical analysis of gross advances to customers, overdue advances and non-performing loans

The following geographical analysis of gross advances to customers, advances overdue for over three months and NPLs is based on the location of the counterparties, after taking into account of the transfer of risk in respect of such advances where appropriate.

(i) Gross advances to customers

	2002	2001
	HK\$m	HK\$m
Hong Kong	304,924	310,953
Mainland China	4,456	7,753
Others	11,654	4,332
	<u>321,034</u>	<u>323,038</u>

(ii) Advances overdue for over three months

	2002	2001
	HK\$m	HK\$m
Hong Kong	17,060	21,713
Mainland China	1,402	3,465
Others	163	120
	<u>18,625</u>	<u>25,298</u>

(iii) Non-performing loans

	2002	2001
	HK\$m	HK\$m
Hong Kong	23,653	30,043
Mainland China	1,755	5,130
Others	251	339
	<u>25,659</u>	<u>35,512</u>

Unaudited Supplementary Financial Information (continued)

(6) Cross-border claims

The information on cross-border claims discloses exposures to foreign counterparties on which the ultimate risk lies, and is derived according to the location of the counterparties after taking into account any transfer of risk. In general, such transfer of risk takes place if the claims are guaranteed by a party in a country which is different from that of the counterparty or if the claims are on an overseas branch of a bank whose head office is located in another country. Only regions constituting 10% or more of the aggregate cross-border claims are analysed by geographical areas and disclosed as follows:

	Banks and other financial institutions	Public sector entities	Others	Total
	HK\$m	HK\$m	HK\$m	HK\$m
At 31 December 2002				
Asia, other than Hong Kong				
- Mainland China	36,489	2,665	5,426	44,580
- Others	44,078	6,015	4,160	54,253
	<u>80,567</u>	<u>8,680</u>	<u>9,586</u>	<u>98,833</u>
North America				
- United States	8,133	10,594	15,703	34,430
- Others	12,158	2,647	14	14,819
	<u>20,291</u>	<u>13,241</u>	<u>15,717</u>	<u>49,249</u>
Western Europe				
- Germany	36,172	—	10,743	46,915
- Others	109,843	1,451	12,511	123,805
	<u>146,015</u>	<u>1,451</u>	<u>23,254</u>	<u>170,720</u>
Total	<u><u>246,873</u></u>	<u><u>23,372</u></u>	<u><u>48,557</u></u>	<u><u>318,802</u></u>

Unaudited Supplementary Financial Information (continued)

(6) Cross-border claims (continued)

	Banks and other financial institutions	Public sector entities	Others	Total
	HK\$m	HK\$m	HK\$m	HK\$m
At 31 December 2001				
Asia, other than Hong Kong				
- Mainland China	86,190	2,616	8,346	97,152
- Others	47,615	13,155	1,991	62,761
	<u>133,805</u>	<u>15,771</u>	<u>10,337</u>	<u>159,913</u>
North America				
- United States	17,086	16,955	8,678	42,719
- Others	17,217	1,571	47	18,835
	<u>34,303</u>	<u>18,526</u>	<u>8,725</u>	<u>61,554</u>
Western Europe				
- Germany	34,533	7	2,645	37,185
- Others	108,764	3,165	1,289	113,218
	<u>143,297</u>	<u>3,172</u>	<u>3,934</u>	<u>150,403</u>
Total	<u><u>311,405</u></u>	<u><u>37,469</u></u>	<u><u>22,996</u></u>	<u><u>371,870</u></u>

Unaudited Supplementary Financial Information (continued)

(7) Overdue and rescheduled assets

(a) Overdue and non-performing loans

	2002		2001	
	Amount	% of gross advances to customers	Amount	% of gross advances to customers
	HK\$m		HK\$m	
Gross advances to customers which have been overdue for:				
- six months or less but over three months	2,240	0.70%	4,212	1.30%
- one year or less but over six months	3,486	1.08%	5,427	1.68%
- over one year	12,899	4.02%	15,659	4.85%
Advances overdue for over 3 months	18,625	5.80%	25,298	7.83%
Less:				
Amount overdue for over 3 months and on which interest is still being accrued	(550)	(0.17%)	(1,786)	(0.55%)
Add:				
Amount overdue for 3 months or less and on which interest is being placed in suspense or on which interest accrual has ceased				
- included in rescheduled advances	1,436	0.45%	1,315	0.41%
- others	6,148	1.91%	10,685	3.30%
Gross non-performing loans	25,659	7.99%	35,512	10.99%

At 31 December 2002 and 31 December 2001, there were no advances to banks and other financial institutions which were overdue for over three months.

Unaudited Supplementary Financial Information (continued)

(7) Overdue and rescheduled assets (continued)

(b) Other overdue assets

	2002	2001
	HK\$m	HK\$m
Overdue for:		
- six months or less but over three months	3	9
- one year or less but over six months	1	5
- over one year	—	4
	<u>4</u>	<u>18</u>

As at 31 December 2002, other overdue assets represented the accrued interest.

(c) Rescheduled advances to customers

	2002		2001	
	Amount	% of gross advances to customers	Amount	% of gross advances to customers
	HK\$m		HK\$m	
Rescheduled advances to customers	<u>1,464</u>	<u>0.46%</u>	<u>1,814</u>	<u>0.56%</u>

Advances with a specific repayment date are classified as overdue when the principal or interest is overdue and remains unpaid. Advances repayable by regular instalments are classified as overdue when an instalment payment is overdue and remains unpaid. Advances repayable on demand are classified as overdue either when a demand for repayment has been served on the borrower but repayment has not been made in accordance with the instruction or when the advances have remained continuously outside the approved limit that was advised to the borrower.

Rescheduled advances are those advances that have been restructured or renegotiated because of a deterioration in the financial position of the borrower or of the inability of the borrower to meet the original repayment schedule and for which the revised repayment terms, either of interest or of repayment period, are non-commercial. Rescheduled advances which have been overdue for more than three months under the revised repayment terms are included under overdue advances. Rescheduled advances are stated after deduction of accrued interest that has been charged to customers but accrued to a suspense account and before deduction of specific provisions.

As at 31 December 2002 and 31 December 2001, there were no rescheduled advances to banks and other financial institutions.

Unaudited Supplementary Financial Information (continued)

(8) Repossessed assets held

	2002	2001
	HK\$m	HK\$m
Repossessed assets held	<u>2,097</u>	<u>3,323</u>

Repossessed assets are properties or securities in respect of which the Group has acquired access or control (e.g. through court proceedings or voluntary actions by the borrowers concerned) for release in full or in part of the obligations of the borrowers. Upon repossession of the assets, the related loans and advances will continue to be recorded as loans and advances until all collection efforts have been exhausted and the repossessed assets are realised. Specific provisions will be made after taking into account the market value of the repossessed assets which are yet to be disposed. Upon disposal of the repossessed assets, any specific provisions previously made will be utilised to write off the loans and advances.

(9) Risk management

Overview

Management of risk is fundamental to the business of the Group and is an integral part of its strategy. The principal types of risk inherent in the Group's business include credit risk, market risk (including interest rate and exchange rate risk), liquidity risk and operational risk. The Group's risk management goal is to maximise its long-term risk-adjusted return on capital, reduce the wide volatility in earnings and increase shareholder value, while maintaining its risk exposures within acceptable limits.

Risk Management Structure

The Bank's risk management policies are designed to identify and analyse credit risk, market risk, liquidity risk and operational risk, to set appropriate risk limits, and to continually monitor these risks and limits by means of administrative procedures and information systems. The Bank continually modifies and enhances its risk management policies and procedures to reflect changes in markets and products.

To achieve the Bank's risk management goals, the Bank established, in connection with its reorganisation, a more centralised, independent and comprehensive risk management structure that involves the following elements:

- A standardised corporation governance structure to provide active oversight and participation by the Board of Directors, committees and senior management;
- reporting lines that are independent of the Bank's Strategic Business Units ("SBUs");

Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Risk Management Structure (continued)

- uniform risk management policies, procedures and limits by which the Bank identifies, measures, monitors and controls inherent risks;
- improved risk measurement, monitoring and management information systems to support business activities and risk management; and
- clearly defined risk management responsibilities and accountability.

The Bank has developed and implemented comprehensive risk management policies and procedures to identify, measure, monitor and control credit risk, market risk, liquidity risk and operational risk across the organisation. The RMC under the Board of Directors is responsible for approving risk management policies and procedures and significant asset and liability management policies proposed by the ALCO.

Each SBU is responsible for implementation of appropriate policies, procedures and controls in relation to risk management. Our CRO oversees and monitors the operations of the Risk Management Department (“RMD”) and reports directly to the RMC. Our CRO is also responsible for assisting the Chief Executive on the bank-wide credit risk, market risk and operational risk management and submitting to the RMC the independent risk management report each month.

CFO has oversight responsibilities for the soundness of the Group’s capitalization and earnings. In addition, our CFO, with assistance of the Treasurer, monitors the bank-wide interest rate risk and liquidity risk and reports the financial position of the bank relating to interest rate risk and liquidity risk to the ALCO and the RMC on a regular basis.

The Bank’s principal banking subsidiaries, Nanyang and Chiyu Banking Corporation Limited, also face the same types of inherent business risks and they adopt consistent risk management strategies and policies as the Bank. These subsidiaries execute their risk management strategy independently and report to the Bank’s management on a regular basis.

Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Credit Risk Management

Credit risk is the risk that a customer or counterparty will be unable or unwilling to meet a commitment that it has entered into with the Bank. Credit risk arises principally from the Bank's lending, trade finance and treasury operations.

The Bank's primary goal in credit risk management is to maximise its risk-adjusted rate of return while maintaining its credit risk exposure within acceptable parameters. In particular, the Bank has developed and implemented comprehensive policies and procedures to identify, measure, monitor and control credit risk across the organisation. The Bank's Board of Directors, with the assistance of the RMC, sets the Group's overall risk management strategy and policies, and the Group's overall risk limits and credit authorisation guidelines. The RMC is responsible for reviewing and approving the Group's risk management policies and procedures as well as modifications to these policies and procedures. The Bank's credit risk management structure seeks to meet its primary goal by:

- establishing an appropriate credit risk environment;
- enforcing prudent procedures for approving credits;
- maintaining an appropriate credit administration, measurement and monitoring process; and
- ensuring adequate independent oversight and control over credit risk.

Consistent with the Bank's overall risk management objectives, the key principles that ensure effective implementation of the Bank's credit risk management strategy are:

- balancing the Bank's tolerance for risk with the level of expected returns;
- diversifying the Bank's loan portfolio by geographic regions, industries, products, customers, maturities and currencies;
- maintaining the independence of the credit review process to ensure risk assessment and monitoring are conducted in an objective and comprehensive manner;
- emphasising the importance of cash flow as an essential factor in assessing applicants' repayment ability;
- compliance with legal and regulatory requirements;

Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Credit Risk Management (continued)

- assigning clearly defined credit risk management responsibilities and accountability to each relevant operating unit and people involved in the risk management process;
- avoiding over-reliance on collateral and guarantees;
- accurate measurement and full disclosure of credit risk exposure; and
- maintenance of consistent credit policy.

Credit Risk Management Structure

The Bank's Board of Directors, representing the shareholders' overall interests, is responsible for determining its credit risk management strategic objectives and principles. The Board, with the aim of maximising the Bank's risk-adjusted returns as well as shareholders' wealth, holds ultimate responsibility for the Bank's overall credit risk management process.

The RMC is a board level committee that has the responsibility of determining and revising the Bank's credit risk management policies and procedures.

The Bank believes that independence and proper checks-and-balances are of critical importance in effective risk management. To this purpose, in the Bank's managerial/organisational structure, the RMD and the Audit Department are placed onto the hierarchical position in which they directly report to the RMC and Audit Committee respectively. All these committees and departments form an independent line of control.

In addition, respective responsibilities, accountabilities and authorities related to credit risk management are clearly defined throughout the Bank.

The Chief Executive is responsible for, among other things, implementing the credit risk management strategy and significant policies approved by the Board. The Chief Executive is also charged with balancing the Bank's goal of generating a high yield on its assets with the need to maintain risk exposure within the shareholder's tolerance level.

The Credit Committee has primary responsibility for reviewing and approving loans exceeding the credit extension limit of the deputy chief executives of credit initiation unit, loans exceeding the credit extension limit of the head of the Special Assets Management Department in the course of restructuring classified loans, loans exceeding the veto right of the CRO and applications which have been vetoed by our CRO and in respect of which an appeal has been lodged with the credit committee.

Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Credit Risk Management Structure (continued)

The Bank's credit initiation units, such as Corporate Banking, Retail Banking and China Business Head Office, act as the first line of risk control. They are required to conduct business activities within the limits of delegated authority and in accordance with the Bank's credit risk management strategy, policies and procedures.

The RMD, being structurally independent to credit initiation units, assists the Chief Executive in managing credit risk based on the credit risk management strategies and policies. It also provides independent due diligence relating to identifying, measuring, monitoring and controlling credit risk.

To avoid any potential conflicts of interest, the credit review functions are independent of the business development units. Multi-level credit approval authorities are set depending mostly on the credit officers' professional experience, skill and responsibilities. All credit approval and review authorities originate from the Bank's Board of Directors.

The Special Assets Management Department is responsible for the collection of NPLs. Other departments, though not specified above, are also charged with relevant matters in relation to credit risk management.

Credit Approval Procedures

The Bank employs discriminatory approval procedures for high-risk loans and low-risk loans.

Low-risk credit transactions that fulfil certain requirements relating to credit types, loan purposes, loan amount, guarantee, collateral coverage and security adequacy are processed using low-risk loan approval procedures. Under these procedures, authorised credit officers in credit initiation units may approve this type of credit applications without prior review by the RMD. The corresponding loan review officer in the RMD should conduct independent post-approval reviews of such pre-approved low-risk credit transactions and assess if initial credit decisions have been made in accordance with the established procedures.

For high-risk loans, credit officers in credit initiation units can only accept and review loan applications and make the initial lending decisions. These credit applications are then independently evaluated by Review Officers in the RMD in respect of compliance with policies and procedures, adequacy of credit risk assessment, and information sufficiency. The RMD is authorised to exercise the right of veto or concurrence based on the review conclusions.

Significant loans include loans exceeding the credit extension limit of the deputy chief executives of the Group's credit initiation units, loans exceeding the credit extension limit of the head of the Special Assets Management Department in the course of restructuring classified loans, loans exceeding the approval right of the CRO and loan applications which have been vetoed by our CRO and in respect of which an appeal has been lodged with the Credit Committee. Significant loans are reviewed and approved by the Credit Committee.

Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Credit Risk Assessment

The result of credit risk assessments is a critical factor in making credit decisions. The Bank's credit assessment emphasises a thorough understanding of the purpose and structure of the loan, the borrower's financial status, cash flow position and repayment ability as well as business management. The Bank also evaluates the industry risk associated with the corporate borrowers. When assessing an individual loan application, the Bank considers overall credit risk at the portfolio level.

Credit Risk Monitoring

The Bank has well-established policy and procedure to monitor credit risk and limits consistently and continuously by means of robust and just-in-time administrative information systems. An independent dedicated division in RMD conducts thorough and comprehensive monitoring on each obligor and group of obligors to identify and control the individual and overall credit risk in our loan portfolio.

An early alert program for potential problem customers has been established in order to detect early signs of deterioration in credit status of obligors and to trigger closer monitoring to prevent further deterioration. On the other hand, a conservative real property collateral discount policy has been implemented to reflect the current stagnant property market in Hong Kong.

To achieve sustainable reduction of the NPLs and improvement on asset quality, the Bank has set up internal targets to evaluate the effort and performance in the resolution of criticised loans. RMD provides regular monitoring reports on the progress to senior management for high-level oversight. An incentive scheme has also been developed to provide appreciation and reward to those who have made the most contribution and merit in the progress.

Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Market Risk Management

Market risk is the risk that the movements in interest rates or market prices will result in losses in on- and off-balance sheet positions. The Bank's market risk arises from customer-related business and from position taking. Market risk trading positions are subject to daily mark-to-market valuation.

Market risk is managed within risk limits approved by the RMC. The overall risk limits are set into sub-limits by reference to different risk factors, which are interest rate, foreign exchange, commodity and equity prices. Considering the different nature of the products involved, limits are set by using a combination of risk measurement techniques, including position limits and sensitivity limits.

The Market Risk Division in the RMD is responsible for the daily market risk management. Through the daily risk monitoring process, the Market Risk Division measures risk exposures against approved limits and initiates specific action to ensure that the overall and individual market risks are managed within an acceptable level.

Value at Risk ("VaR") is a statistical technique which estimates the potential losses that could occur on risk positions taken due to movements in foreign exchange, interest rates, commodity and equity prices over a specified time horizon and to a given level of confidence. The model used by the Bank to calculate portfolio and individual VaR on a variance/covariance basis, uses historical movements in market rates and prices, a 99% confidence level and a 1-day holding period and generally takes account of correlations between different markets and rates.

At 31 December 2002, the VaR for all trading market risk exposure of the Bank was HK\$3.3 million (2001: HK\$1.6 million), the VaR for all trading interest rate risk exposure was HK\$2.1 million (2001: HK\$1.5 million) and the VaR for all trading foreign exchange risk exposure was HK\$1.1 million (2001: HK\$1.2 million). The average VaR for the year ended 31 December 2002 was HK\$3.3 million.

Prior to the Restructuring and Merger, market risk of each of the predecessor entities was managed on an individual basis. As a result, the average, high and low daily VaR from market risk-related trading activities of the Bank for the year ended 31 December 2001 is not comparable and hence not presented.

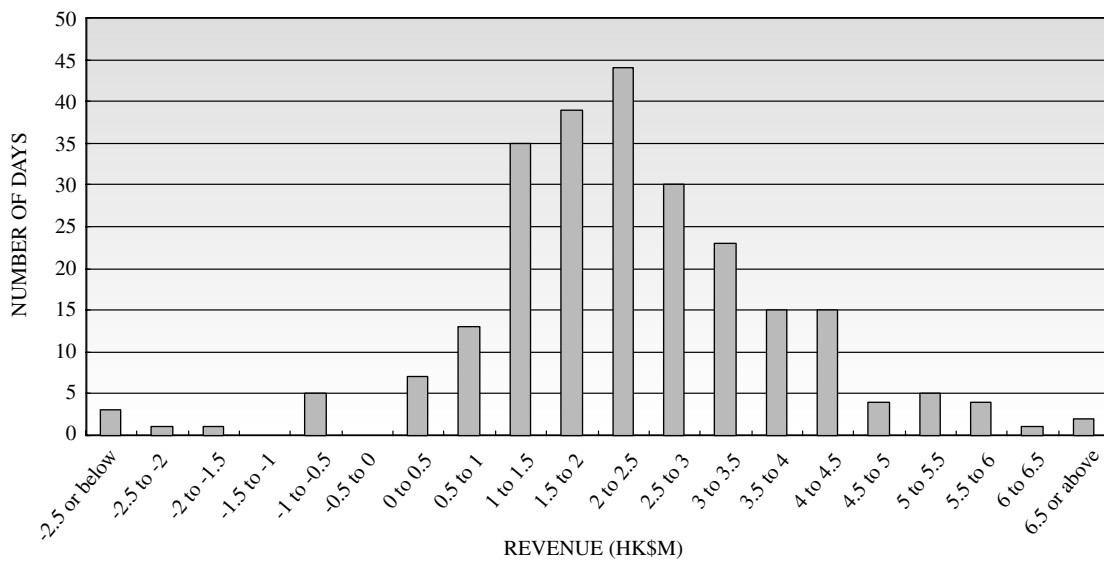
Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Market Risk Management (continued)

For the year ended 31 December 2002, the average daily revenue of the Bank earned from market risk-related trading activities was HK\$2.3 million (2001: HK\$2.0 million). The standard deviation of these daily trading revenues was HK\$1.5 million (2001: HK\$1.1 million). An analysis on the frequency distribution of daily trading revenues illustrated below shows that ten (2001: three) losses were recorded out of 247 trading days for the year ended 31 December 2002 and the maximum daily loss was HK\$2.8 million (2001: HK\$2.8 million). The most frequent result was a daily trading revenue of between HK\$2 million to HK\$2.5 million (2001: HK\$1.5 million to HK\$2.0 million). The highest daily revenue was HK\$7.0 million (2001: HK\$5.4 million).

Daily Distribution of Trading Market Risk Revenues For The Year Ended 31 December 2002



Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Foreign Exchange Risk Management

The Bank provides foreign exchange deposit, margin trading and forward transaction services to its customers. The Bank's trading activities in the foreign currency markets expose it to exchange rate risk. The Bank manages exchange rate risks through its interbank market activities. In particular, the Bank mitigates exchange rate risks by establishing position limits and limits on the loss of the whole foreign exchange trading floor. All these limits are approved by the RMC. The RMD is responsible for monitoring foreign exchange exposure and related stop-loss limits on a day-to-day basis as well as controlling the Bank's credit risk exposure arising from foreign exchange transactions.

Interest Rate Risk Management

The Bank's balance sheet consists predominantly of Hong Kong dollar denominated interest rate sensitive assets and liabilities. The Bank's primary sources of interest rate risk are mismatches in the maturities or re-pricing periods of these assets and liabilities and movements in interest rates. In addition, different pricing bases for different transactions may also lead to interest rate risk for the Bank's assets and liabilities within the same re-pricing period.

The Bank's Treasurer is responsible for formulating the policy and developing risk management system to assist the Bank's ALCO in identifying, measuring, monitoring and controlling interest rate risk. The Treasurer uses gap analysis to measure the Bank's exposure to interest rate risk. The gap is the difference between the amount of interest-earning assets and interest-bearing liabilities that mature or must be re-priced within a specific time band. Gap analysis provides the Bank with a static view of the maturity and re-pricing characteristics of its balance sheet positions. The Treasurer measures the gaps by classifying all assets, liabilities and off-balance sheet items for each currency into appropriate time bands according to contracted maturities or anticipated re-pricing time bands. The magnitude of the gaps indicate the extent to which the Bank is exposed to the risk of potential changes in the margins on new or re-priced assets and liabilities, and are controlled according to the gap limits approved by the Board of Directors. The potential risks associated with these gaps are assessed through simulated interest rate scenarios to testify that the net interest income variations are within the manageable range sanctioned by the Board. The impact of basis risk is gauged by the change in net interest income as a result of uncorrelated movements between the base lending rate and key money market rate. All the results are reported daily.

Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Liquidity Risk Management

Liquidity risk arises in the funding of lending, trading and investment activities and in the management of trading positions. Liquidity risk includes both the risk of unexpected increase in the cost of funding to refinance the Bank's asset portfolio at appropriate maturities and the risk of being unable to liquidate a position in a timely manner and/or at a reasonable price. The goal of liquidity management is for the Bank to be able, even under adverse market conditions, to meet all its maturing repayment obligations on time and to fund all of its investment opportunities.

The Bank maintains flexibility in meeting its funding requirements by maintaining diverse sources of liquidity. The Bank funds its operations principally by accepting deposits from retail and corporate depositors. The Bank may also borrow in the short-term interbank markets, although it is typically a net lender of funds. In addition, the Bank may from time to time raise funds through the sale of investments.

The Bank uses the majority of funds raised to extend loans, to make investments in debt securities or to conduct interbank placements. Generally deposits have a shorter average maturity than interbank placements that in turn are of shorter average maturity compared with that of loans or investments.

The Bank maintains a buffer portfolio of liquid, high quality securities that is managed by the Bank's Treasurer under the supervision of the CFO and the ALCO. These securities may generally be sold at any time at market prices to meet the Bank's emergent liquidity needs. The Bank may also manage its liquidity by borrowing in the interbank markets on a short-term basis. The interbank markets generally provide an adequate amount of liquidity, at borrowing rates that are subject to market conditions.

The primary goal of the Bank's asset and liability management strategy is to achieve an optimal return while ensuring adequate levels of liquidity and capital within an effective risk control framework and at reasonable cost of funding. The Bank's ALCO is responsible for establishing these policy directives and works closely with the Treasurer to ensure that the Bank maintains adequate levels of liquidity and secures the lowest possible cost of funding, while closely planning and monitoring the Bank's on- and off-balance sheet assets and liabilities with regard to the risk incurred. The Treasurer adjusts, as necessary, the Bank's liquidity and foreign exchange positions in line with the policies of ALCO, and also provides reporting and analytical

Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Liquidity Risk Management (continued)

services to ALCO with respect to current and planned positions taken for investment, funding and foreign exchange management purposes. In particular, the Bank has implemented various measures to:

- improve its management information system to provide timely information on the movement of its liquid assets and that of its customer deposits on a daily, weekly and monthly basis;
- monitor liquidity ratios in compliance with the HKMA's requirements;
- prepare regular maturity gap analysis to enable management to review and monitor the Bank's liquidity position on a timely basis;
- conduct scenario analysis to estimate the impact of various risk factors on the liquidity position;
- establish a range of liquidity risk factors for monitoring purposes and a liquidity risk warning index system to detect early signs of any irregularities; and
- create a three-tier response system to effectively deal with any emergencies.

Capital Management

The Group monitors the adequacy of its capital using the CAR as one of the major measurements, which is subject to the HKMA regulatory requirements. The Group maintained its capital to comply with all the statutory standards for all the periods presented in the report. On consolidated basis, the Bank's unadjusted CAR and adjusted CAR incorporating market risk decreased slightly from 14.38% and 14.57% as at the end of last year to 13.99% and 14.39% respectively.

Operational Risk Management

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It is the Bank's objective to manage this risk in line with the best practice of the industry.

In order to achieve effective internal control, the Bank is to maintain adequate documentation of its business processes and operating procedures. It also emphasises on segregation of duties and independent authorisation among all business activities.

Unaudited Supplementary Financial Information (continued)

(9) Risk management (continued)

Operational Risk Management (continued)

Every department is primarily responsible for managing operational risk and establishing procedures within their own business functions. This is monitored by the Operational Risk Division of RMD and Audit Department, which play important roles in periodic review on various business operations.

During the year, the Bank monitors operational risk losses and periodically collects loss data to meet the requirements of Basle's new capital accord.

Our Business Continuity Plan was further enhanced in the year. Adequate facilities are maintained and tested for the recovery of critical business functions in the event of a disaster. The Bank also arranges insurance cover to mitigate potential losses in respect of operational risk.