

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Consolidated Financial Review

With effect from 1 January 2005, the Group is required to prepare its financial statements in accordance with new and revised HKFRSs and HKASs (thereafter collectively refer to as the "new accounting standards"). Due to the change in accounting standards, certain 2004 comparative figures are not strictly comparable.

Compared to the same period last year, the Group's profit attributable to shareholders increased by 16.9% to HK\$6,522 million. Earnings per share was HK\$0.6169, up HK\$0.089. Return on average total assets and return on average shareholders' funds was 1.61% and 18.39%, up

0.13 and 0.20 percentage point against the first half of 2004.

The improvement in the Group's results was attributable to higher operating income, while operating expenses were kept at last year's level. Operating profit before impairment was correspondingly better than the same period last year. Attributable profit was also boosted by a substantial loan impairment allowance write-back and a large investment property revaluation gain. The latter represents a change in our accounting policies as no investment property revaluation was performed on 30 June 2004.

### Financial Performance

HK\$m, except percentage amounts	<b>Half-year ended 30 June 2005</b>	Half-year ended 31 December 2004	Half-year ended 30 June 2004
Operating income	<b>8,225</b>	7,834	8,023
Operating expenses	<b>(2,676)</b>	(2,838)	(2,667)
Operating profit before impairment/provisions on advances	<b>5,549</b>	4,996	5,356
Reversal of impairment allowances/write-back of provisions	<b>1,435</b>	388	1,240
Others	<b>939</b>	2,092	180
Profit before taxation	<b>7,923</b>	7,476	6,776
Profit attributable to equity holders of the Company	<b>6,522</b>	6,382	5,581
Earnings per share (HK\$)	<b>0.6169</b>	0.6036	0.5279
Return on average total assets	<b>1.61%</b>	1.63%	1.48%
Return on average shareholders' funds	<b>18.39%</b>	19.66%	18.19%
Net interest margin	<b>1.59%</b>	1.54%	1.56%
Non-interest income ratio	<b>28.74%</b>	27.44%	31.33%
Cost to income ratio	<b>32.53%</b>	36.23%	33.24%

Analysis of the financial performance, business operations and risk management of the Group for the first half of 2005 is set out in the coming sections.

### Significant Changes in Accounting Policies

Following are the new accounting standards that had the most financial impact on the results.

Standards and interpretation	Significant financial impact for the first half of 2005
<ul style="list-style-type: none"> <li>HKAS 39: Financial Instruments – Recognition and Measurement</li> </ul>	<ul style="list-style-type: none"> <li>Affected interest income, fees and commission income, net trading income and impairment allowances</li> <li>Affected classification of assets and liabilities</li> </ul>
<ul style="list-style-type: none"> <li>HKAS 40: Investment Property</li> </ul>	<ul style="list-style-type: none"> <li>Movement of revaluation reserve of investment properties to retained earnings in the opening balance adjustment</li> <li>Change in fair value of investment properties was recognised directly in the profit and loss account</li> </ul>
<ul style="list-style-type: none"> <li>HKAS 12: Income Taxes – HKAS Interpretation 21</li> </ul>	<ul style="list-style-type: none"> <li>Provision of deferred tax on the revaluation surplus of investment properties</li> </ul>

In this management's discussion and analysis, the impact of adoption of the new accounting standards is described where appropriate. The notes to the accounts set out the changes in accounting policies in detail.

### Net Interest Income and Margin

HK\$m, except percentage amounts	Half-year ended 30 June 2005	Half-year ended 31 December 2004	Half-year ended 30 June 2004
Interest income	<b>10,065</b>	8,374	7,304
Interest expense	<b>(4,204)</b>	(2,690)	(1,795)
Net interest income	<b>5,861</b>	5,684	5,509
<i>Net interest income – comparable basis</i>	<b>5,900</b>	5,684	5,509
Average interest-earning assets	<b>744,479</b>	734,174	708,490
Net interest spread	<b>1.43%</b>	1.43%	1.49%
Net interest margin	<b>1.59%</b>	1.54%	1.56%
<i>Net interest margin – comparable basis</i>	<b>1.60%</b>	1.54%	1.56%

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Net interest income increased by HK\$352 million, or 6.4%, to HK\$5,861 million on a year-on-year basis. Average interest-earning assets grew by HK\$35,989 million, or 5.1%, to HK\$744,479 million. Net interest spread and net interest margin were 1.43% and 1.59% respectively. If the impact of the new accounting standards was removed, the comparable net interest income was HK\$5,900 million, HK\$391 million or 7.1% higher than the same period last year. Similarly, net interest margin was 1.60%, or 4 basis points higher than that of the first half in 2004 on a comparable basis.

The total negative impact of applying new accounting standards on the Group's net interest income amounted to approximately HK\$39 million. Net interest income was affected in the following ways:

- Interest accrued on impaired loans using effective interest rate was not recognised under the previous accounting regime.
- Swap points of foreign exchange swap contracts previously accounted for as interest was reported as net trading income under the new accounting standards.
- Directly attributable loan fees and costs previously recognised as commission income and expenses were reported as interest income using the effective interest calculation.

In the first half of 2005, the Hong Kong dollar interest rate remained at a low level. However, subsequent to the introduction of refinement to the operation of the Linked Exchange Rate System by the HKMA in May 2005, the Hong Kong dollar interest rate rebounded, substantially narrowing the differential with US dollar

interest rate. Average one-month HIBOR increased to 2.02% as compared to 0.11% for the first half of 2004. Average one-month LIBOR also rose steadily to 2.88% from 1.13%.

Gross yield on average loans increased by 51 basis points. However, the weighted average pricing on the residential mortgage portfolio declined by 25 basis points compared to the same period last year, dropping from 2.12% below best lending rate for the first half of 2004 to 2.37% in the current period. Facing a substantially different interest rate environment, the Group adjusted the mortgage pricing strategy by raising the effective interest rate and reducing cash rebate incentives on new loans in the second quarter. Gross yield on debt securities increased by 76 basis points as the Group continued to diversify its investment portfolio for yield enhancement. However, the improvement in net contribution from the debt securities portfolio was held back by the flattening yield curve. Deposit spread widened as a result of the Group's conscious effort in managing funding costs. However, cost of funding rose as average interest rates on savings and time deposits increased by 33 basis points and 97 basis points respectively.

Compared to the second half of 2004, on a comparable basis, net interest income increased by HK\$216 million, or 3.8%. Net interest spread was flat. Net interest margin rose by 6 basis points mainly due to the increase in contribution of net free funds. Gross yields on average loans and debt securities rose by 48 and 51 basis points respectively. The improvement in loan spread was limited as the yield on residential mortgages continued to narrow in a very competitive environment. The weighted average pricing on residential mortgages was 12 basis points lower than that in the second half of 2004.

### Net Fees and Commission Income

HK\$'m	<b>Half-year ended 30 June 2005</b>	Half-year ended 31 December 2004	Half-year ended 30 June 2004
Bills commissions	<b>257</b>	277	270
Loan commissions	<b>124</b>	256	234
Wealth management income			
Stockbroking	<b>330</b>	374	462
Asset management	<b>85</b>	58	175
Life insurance	<b>135</b>	67	127
Retail bonds and structured notes	<b>74</b>	58	40
General insurance	<b>58</b>	68	52
Trust services	<b>49</b>	43	32
Payment services	<b>179</b>	184	165
Credit cards	<b>372</b>	350	316
Others	<b>342</b>	351	348
Fees and commission income	<b>2,005</b>	2,086	2,221
Fees and commission expenses	<b>(508)</b>	(576)	(510)
Net fees and commission income	<b>1,497</b>	1,510	1,711
<i>Net fees and commission income – comparable basis</i>	<b>1,601</b>	1,510	1,711

Net fees and commission income fell by HK\$214 million, or 12.5%, to HK\$1,497 million, primarily due to the decreases in commissions from stockbroking, sales of investment funds and the impact from the adoption of the new accounting standards. The new accounting standards resulted in a reduction of net fees and commission income, primarily in the form of loan fees, by HK\$104 million. Excluding the impact of the new accounting standards, net fees and commission income would have registered a smaller drop of HK\$110 million, or 6.4%.

Against the backdrop of raising interest rates and the strong performance in the first half of 2004, income from stockbroking and sales of investment funds declined by HK\$132 million or 28.6%, and HK\$90 million or 51.4%, respectively in the first half of 2005 compared to the same period in 2004. Customers demanded investments with higher potential returns amid a rising interest rate environment. Consequently sales of capital

guaranteed funds dropped significantly from over 50% of total fund sales in the first half of 2004 to less than 10% in the first half of 2005. Nevertheless, structured products and open-ended funds became more popular in the market and the Group was able to capture the growth opportunities resulting in 87.4% and 12.0% increases in sales volume. Commissions from stockbroking reduced as a result of the decline in market transaction volume.

Loan commissions fell by HK\$110 million, or 47.0%. Upon adoption of the new accounting standards, directly attributable loan fees of HK\$133 million were amortised to interest income over the expected life of the loans as part of the effective interest calculation. Excluding the impact of the new accounting standards, loan fees would have registered a modest increase. Bills commission dropped by HK\$13 million, or 4.8%, due to keen pricing competition.

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Fees from card business recorded growth of 17.7%, driven by the increases in cardholder spending and merchant acquiring volumes by 20.4% and 21.5% respectively.

Compared to the second half of 2004, on a comparable basis, net fees and commission income increased by HK\$91 million or 6.0%, mainly attributable to the growth of wealth management income. The income from sales of life insurance and investment funds showed the strongest growth of 101.5% and 46.6% respectively.

### Net Trading Income

HK\$m	<b>Half-year ended 30 June 2005</b>	Half-year ended 31 December 2004	Half-year ended 30 June 2004
Foreign exchange and foreign exchange products	<b>596</b>	488	610
Interest rate instruments	<b>129</b>	(12)	(1)
Equity instruments	<b>4</b>	7	21
Commodities	<b>17</b>	22	32
Net trading income	<b>746</b>	505	662
<i>Net trading income – comparable basis</i>	<b>510</b>	505	662

Net trading income increased by HK\$84 million, or 12.7%, to HK\$746 million as compared to the first half of 2004. The adoption of HKAS 39 increased the volatility of the revenue recognition in the trading activities. On a comparable basis, after exclusion of the impact from the adoption of HKAS 39, net trading income declined by 23.0%.

Net trading income from foreign exchange and foreign exchange products decreased by HK\$14 million, or 2.3%, to HK\$596 million. Excluding about HK\$87 million gains derived from the changes in fair value of foreign exchange swap contracts recognised under the new accounting standards, the comparable decline was 16.6%. Previously these contracts were accounted for as interest income on an accruals basis. The lower income from foreign exchange business was attributable to a lack of customer interest in currency trading as a result of a weak US dollar. There were also concerns that pressure on the RMB to appreciate might also put

pressure for a stronger Hong Kong dollar, which further dampened public interest in holding other currencies.

Net trading income from interest rate instruments mainly included changes in fair value relating to trading securities, other financial assets at fair value through profit or loss, available-for-sale securities designated in fair value hedges, interest rate derivatives and financial liabilities at fair value through profit or loss. The increase in income was mainly derived from the changes in fair value of interest rate derivatives and retail certificate of deposits designated at fair value through profit or loss. On a comparable basis, when hedge accounting on accruals basis was usually applied in previous years, the net gain from interest rate instruments was minimal for the first half of 2005 and two halves of 2004.

Compared to the second half of 2004, on a comparable basis, net trading income stayed flat amid a quiet market environment.

### Operating Expenses

HK\$'m, except percentage amounts	<b>Half-year ended 30 June 2005</b>	Half-year ended 31 December 2004	Half-year ended 30 June 2004
Staff costs	<b>1,654</b>	1,664	1,627
Premises and equipment expenses	<b>321</b>	379	346
Depreciation on owned fixed assets	<b>286</b>	292	293
Other operating expenses	<b>415</b>	503	401
Operating expenses	<b>2,676</b>	2,838	2,667
<i>Operating expenses – comparable basis</i>	<b>2,797</b>	2,838	2,667
Cost to income ratio	<b>32.53%</b>	36.23%	33.24%
<i>Cost to income ratio – comparable basis</i>	<b>34.40%</b>	36.23%	33.24%

Operating expenses rose slightly by HK\$9 million, or 0.3%, to HK\$2,676 million.

In the first half of 2005, the Group adjusted the estimated useful life of the premises by referring to the lease terms of the land element as the depreciable period on the basis that the major portion of property values in Hong Kong rests with the land element. Under the previous accounting standards, the Group separated the land and building elements using a 50 : 50 split and depreciated according to the corresponding lives of the

two elements. The use of one common life under the current treatment has led to a lower depreciation charge. Depreciation should have been increased by HK\$121 million to HK\$407 million in view of the substantial upward revaluation of premises in 2004.

Staff costs slightly increased by HK\$27 million, or 1.7%, mainly attributable to upward adjustment of staff salaries in April 2005. Headcount measured in full time equivalents was 12,698 at the end of June 2005, a decrease of 257 from 30 June 2004.

### Loan Impairment Release

HK\$'m	<b>Half-year ended 30 June 2005</b>	Half-year ended 31 December 2004	Half-year ended 30 June 2004
Loan impairment release/(charge)			
– New allowances	<b>(796)</b>	–	–
– Releases	<b>1,123</b>	–	–
– Recoveries of loans previously written off	<b>1,108</b>	–	–
Specific provisions			
– New provisions	–	(709)	(811)
– Releases	–	524	1,327
– Recoveries of loans previously written off	–	623	733
General provisions	–	(50)	(9)
Credit to profit and loss account	<b>1,435</b>	388	1,240

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Under the new accounting standards and accounting policies, impairment allowances of individually significant loans and advances showing objective evidence of impairment are calculated using discounted future cash flow analysis. For the remaining loans and advances, impairment allowances are collectively assessed by using statistical models on portfolios of loans and advances grouped by similar credit characteristics. The Group reported a release of allowances of HK\$1,123 million in the first half of 2005. The release was the result of improvement in asset quality due to a solid growth in economy, lower bad debt migration rate and rise in collateral values. This release was partially offset by an

increase of HK\$796 million in new impairment allowances.

For the first half of 2005, the active property market also facilitated disposals of collateral. As a result, recoveries of loans previously written off increased by HK\$375 million, or 51.2%, to HK\$1,108 million.

### *Revaluation of investment properties*

Revaluation gains on investment properties of HK\$918 million was recognised through the profit and loss account on the adoption of HKAS 40. The related deferred tax charge amounted to HK\$155 million.

### *Adjustments to the opening balance of total reserves at 1 January 2005*

The following table displays the adjustments to the opening balance of total reserves at 1 January 2005.

HK\$'m	Retained earnings	Other reserves	Total	Notes
At 31 December 2004	<b>12,541</b>	<b>3,116</b>	<b>15,657</b>	
Opening adjustments:				
HKAS 39				
– Reclassification and remeasurement of debt securities	<b>953</b>	–	<b>953</b>	i
– Recognition of derivatives at fair value	<b>(924)</b>	–	<b>(924)</b>	
– Loan loss provision write-back	<b>3,800</b>	–	<b>3,800</b>	ii
– Taxation	<b>(657)</b>	–	<b>(657)</b>	iii
– Others	<b>26</b>	–	<b>26</b>	
HKAS 40 – transfer of investment properties revaluation reserve	<b>623</b>	<b>(623)</b>	–	iv
HKAS 40 – taxation	<b>(1)</b>	–	<b>(1)</b>	
HKAS Interpretation 21 – deferred tax	<b>(636)</b>	–	<b>(636)</b>	v
Transfer to regulatory reserve	<b>(3,410)</b>	<b>3,410</b>	–	
At 1 January 2005	<b>12,315</b>	<b>5,903</b>	<b>18,218</b>	

- i. Certain held-to-maturity securities were classified as available-for-sale securities and securities at fair value through profit or loss at 1 January 2005 and were remeasured at fair value. The opening adjustment represents the difference between the fair value and the amortised cost.
- ii. Transfer general provisions and specific provisions in excess of loan impairment allowances into retained earnings.
- iii. Provision of deferred tax and current tax on the opening adjustments.
- iv. Transfer of revaluation reserve of investment properties to retained earnings.
- v. Provision of deferred tax on the revaluation surplus of investment properties.

### **Estimation of the effect on adoption of new accounting standards**

The following table provides differences in the profit had the previous accounting standards and accounting policies still been applied for the six months ended 30 June 2005. Due to the complexity of the calculation, the analysis is on a best estimate basis.

HK\$'m	Half-year ended 30 June 2005	Notes
Effective yield and others	86	i
Hedging and asset classification	(179)	ii
Impairment	(1,006)	iii
Revaluation of investment properties	(918)	iv
Taxation	382	
<b>Total</b>	<b>(1,635)</b>	

Most differences were attributable to the adoption of HKAS 39 and HKAS 40. The key impacts are summarised in the following notes:

- i. HKAS 39 requires the use of effective yield on interest income recognition for directly attributable loan fees and costs. Effective yield difference affected both net interest income and net fees and commission income.
- ii. Certain derivative financial instruments that were previously not marked to market were now stated at fair value under HKAS 39. On 1 January 2005, the Group reclassified certain held-to-maturity securities to available-for-sale securities and to financial instruments at fair value through profit or loss. The Group also designated certain financial liabilities at fair value through profit or loss such that they were stated at fair value. For the first half of 2005, the changes in fair value of these financial instruments were reflected in the profit and loss account. Differences arising from hedging and asset classification mainly affected net interest income and net trading income.
- iii. Under HKAS 39, individual and collective assessment models are used to determine the impairment allowances for loans and advances. Using this new methodology, the total impairment allowances required for the first half of 2005 was lower than the total allowances established at the beginning of the year resulting in a net write-back. The reduction of the loan impairment allowances was made possible by the continual improvement in the quality of the loan portfolio. Under the previous accounting standards, there would have been an increase in general provisions regardless of the improvement in asset quality.
- iv. HKAS 40 requires fair value changes of investment properties to be reported directly in the profit and loss account. In previous accounting standards, changes in the value of investment properties were treated as a movement in the investment properties revaluation reserve on a portfolio basis. As the Group held an investment properties revaluation reserve as at 31 December 2004, there would have been no impact in the profit and loss account arising from investment property revaluation.

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**Financial Position**

HK\$'m	<b>At 30 June 2005</b>	At 31 December 2004
Cash and short-term funds	<b>113,792</b>	102,647
Placements with banks and other financial institutions maturing between one and twelve months	<b>60,196</b>	107,581
Certificates of deposit held	<b>19,440</b>	22,338
Hong Kong SAR Government certificates of indebtedness	<b>33,900</b>	34,760
Securities investments*	<b>214,376</b>	189,388
Derivative financial instruments	<b>4,711</b>	–
Advances and other accounts	<b>336,290</b>	309,211
Fixed assets and investment properties	<b>22,195</b>	21,877
Deferred tax assets	<b>8</b>	12
Other assets**	<b>8,427</b>	8,962
<b>Total assets</b>	<b>813,335</b>	796,776
Hong Kong SAR currency notes in circulation	<b>33,900</b>	34,760
Deposits and balances of banks and other financial institutions	<b>38,471</b>	34,440
Deposits from customers	<b>627,298</b>	631,330
Trading liabilities and other financial instruments at fair value through profit or loss	<b>8,339</b>	–
Derivative financial instruments	<b>3,619</b>	–
Certificates of deposit issued	<b>3,746</b>	3,788
Deferred tax liabilities	<b>2,407</b>	947
Other accounts and provisions	<b>20,890</b>	21,751
<b>Total liabilities</b>	<b>738,670</b>	727,016
Minority interests	<b>1,294</b>	1,239
Shareholders' funds	<b>73,371</b>	68,521
<b>Total liabilities and capital resources</b>	<b>813,335</b>	796,776

\* At 30 June 2005, securities investments include held-to-maturity securities, available-for-sale securities, trading securities and other financial instruments at fair value through profit or loss based on the classification required under the new accounting standards. At 31 December 2004, securities investments include held-to-maturity securities, other investment in securities and investment securities.

\*\* Trade bills and investments in associates are included in other assets.

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The Group's total assets as at 30 June 2005 were HK\$813,335 million, up HK\$16,559 million, or 2.1%, from end-2004.

- Interbank placings maturing between one and twelve months dropped by HK\$47,385 million, or 44.0%.
- Securities investments rose by HK\$24,988 million, or 13.2%, to HK\$214,376 million.
- The Group continued to actively manage the balance sheet. As a result, short-term surplus funds were reduced and uses of funds by our lending business and securities investment portfolios increased.

### Advances to customers

The Group registered a strong growth in advances to customers by HK\$24,428 million, or 7.8%, to HK\$337,654 million from end-2004.

HK\$m, except percentage amounts	At 30 June		At 31 December	
	2005	%	2004	%
Industrial, commercial and financial	<b>156,225</b>	<b>46.3%</b>	148,034	47.3%
Individuals	<b>132,531</b>	<b>39.2%</b>	124,687	39.8%
Loans for use in Hong Kong	<b>288,756</b>	<b>85.5%</b>	272,721	87.1%
Trade finance	<b>16,049</b>	<b>4.8%</b>	13,279	4.2%
Loans for use outside Hong Kong	<b>32,849</b>	<b>9.7%</b>	27,226	8.7%
Total advances to customers	<b>337,654</b>	<b>100.0%</b>	313,226	100.0%

Loans for use in Hong Kong rose by 5.9%.

- Lending to industrial, commercial and financial sectors recorded a robust expansion by HK\$8,191 million, or 5.5%, from end-2004. In particular, our SME loan portfolio increased by 9.1%.
- Residential mortgage loans (excluding those under the government-sponsored home purchasing schemes) increased by HK\$7,796 million, or 8.2%, to HK\$103,411 million.
- Card advances grew by HK\$93 million, or 2.2%, from end-2004 as a result of an increase in cardholder spending encouraged by a favorable economic environment.

Trade finance increased by HK\$2,770 million or 20.9%. This was largely a result of strong import and export performance in Hong Kong. Loans for use outside Hong Kong was up 20.7%, mainly propelled by the strong growth of corporate lending business in our Mainland branches.

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### Deposits from Customers

HK\$m, except percentage amounts	At 30 June		At 31 December	
	2005	%	2004	%
Demand deposits and current accounts	29,481	4.7%	32,470	5.1%
Savings deposits	241,269	38.1%	296,462	47.0%
Time, call and notice deposits	356,548	56.4%	302,398	47.9%
Structured deposits	5,248	0.8%	–	–
Total deposits from customers	632,546	100.0%	631,330	100.0%

Deposits from customers were HK\$632,546 million, up HK\$1,216 million or 0.2% from end-2004. Time deposits increased by HK\$54,150 million or 17.9%, whereas savings deposits declined by HK\$55,193 million or

18.6%. Owing to a substantial increase in interest rates, we saw a shift of funds from savings deposits to time deposits.

### Asset Quality

HK\$m, except percentage amounts	At 30 June	At 1 January	At 31 December
	2005	2005	2004
Advances to customers	337,654		313,226
Classified impaired loan ratio*	1.89%		2.95%
Impairment allowances	2,976	3,942	–
Regulatory reserve for general banking risks	3,584	3,410	–
Total allowances and regulatory reserve	6,560	7,352	–
General provisions	–	–	5,465
Specific provisions	–	–	2,320
Total provisions	–	–	7,785
Total allowances/provisions as a percentage of advances to customers	0.88%		2.49%
Total allowances and regulatory reserve/provision as a percentage of advances to customers	1.94%		2.49%
Residential mortgage loans – delinquency and rescheduled loan ratio**	0.47%		0.61%
Card advances – delinquency ratio***	0.35%		0.38%

	Half-year ended	Half-year ended
	30 June	30 June
	2005	2004
Card advances – charge-off ratio#	2.87%	4.67%

- \* Percentage of loans that are classified as substandard, doubtful or loss under the HKMA's loan classification system. Upon adoption of HKFRS 5, repossessed assets are initially recognised at the lower of their fair value or the amortised cost of the related outstanding loans on the date of repossession. The related loans and advances are deducted from loans and advances. Details of the accounting policies are set out in the notes to the interim report.
- \*\* Residential mortgage loans exclude those under the Home Ownership Scheme and other government-sponsored home purchasing schemes. Delinquency ratio is measured by a ratio of the total amount of overdue loans (more than three months) to total outstanding loans.
- # Exclude Great Wall cards and computed according to the HKMA's definition.

The Group's classified impaired loans decreased significantly by HK\$2,876 million or 31.1%. Classified impaired loan ratio improved by 1.06 percentage points to 1.89%. We achieved good results in our collection and recovery efforts helped by an improving economy and property market. Total collections amounted to approximately HK\$1.7 billion. Write-offs of classified impaired loans amounted to HK\$0.6 billion. About HK\$0.4 billion of the reduction in classified impaired loans was due to deduction of the loans and advances related to repossessed assets upon the adoption of HKFRS 5.

Impairment allowances amounted to HK\$2,976 million under the categories of individual and collective assessments. The Group also held a regulatory reserve

amounting to HK\$3,584 million. This regulatory reserve balance was created by a transfer of HK\$3,410 million from retained earnings at the beginning of the financial year plus an increase of HK\$174 million in the first six months of this year. Total allowances and regulatory reserve represents 1.94% of total advances to customers, or 103.0% coverage of the classified impaired loans.

The quality of the Group's residential mortgage loans continued to improve. The combined delinquency and rescheduled loan ratio decreased from 0.61% at end-2004 to 0.47%. The negative equity ratio dropped from 3.93% at end-2004 to 1.00%. The quality of card advances also improved, with the delinquency ratio and charge-off ratio dropping from 0.38% and 4.67% to 0.35% and 2.87% respectively.

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### Capital and Liquidity Ratios

HK\$m, except percentage amounts	<b>At 30 June 2005</b>	At 31 December 2004
Tier 1 capital	<b>63,425</b>	60,905
Tier 2 capital	<b>4,724</b>	5,049
Unconsolidated investments and other deductions	<b>(1,019)</b>	(1,257)
<b>Total capital base after deductions</b>	<b>67,130</b>	64,697
Risk-weighted assets		
On-balance sheet	<b>396,597</b>	369,875
Off-balance sheet	<b>33,186</b>	34,045
Deductions	<b>(3,421)</b>	(3,091)
<b>Total risk-weighted assets</b>	<b>426,362</b>	400,829
<b>Total risk-weighted assets adjusted for market risk</b>	<b>427,186</b>	400,977
Capital adequacy ratios		
Before adjusting for market risk		
Tier 1	<b>14.88%</b>	15.19%
Total	<b>15.74%</b>	16.14%
After adjusting for market risk		
Tier 1*	<b>14.85%</b>	15.19%
Total*	<b>15.71%</b>	16.13%

  

	<b>Half-year ended 30 June 2005</b>	Half-year ended 30 June 2004
Average liquidity ratio	<b>39.15%</b>	34.64%

\* The capital adequacy ratios take into account market risks and are calculated in accordance with the relevant HKMA guidelines.

Total capital base after deductions of the Group further increased to HK\$67,130 million, or a 3.8% increase over the balance at 31 December 2004. The increase was primarily due to the increase in retained earnings. The consolidated capital adequacy ratio declined by 0.40 percentage point to 15.74% as at 30 June 2005, mainly due to expansion of on-balance sheet risk-weighted assets. This was attributable to the strong growth in corporate loans and residential mortgage loans, partially offset by the reduction in interbank placements.

The impact of adoption of new accounting standards on the capital base was not significant. In accordance with the HKMA guideline "Impact of the New Hong Kong Accounting Standards on Authorised Institutions' Capital Base and Regulatory Reporting", collective assessment allowances of HK\$1,222 million and regulatory reserve of HK\$3,584 million appropriated from retained earnings were included in Tier 2 capital subsequent to the adoption of HKAS 39. At 31 December 2004, general provisions eligible to Tier 2 capital were capped to HK\$5,049 million.

## BUSINESS REVIEW

Certain year-on-year figures in the following business segment analysis are not strictly comparable.

### Retail Banking

HK\$m, except percentage amounts	Half-year ended 30 June 2005	Half-year ended 30 June 2004	Increase/ (decrease)
Net interest income	3,656	2,724	34.2%
Other operating income	1,228	1,444	(15.0%)
Operating income	4,884	4,168	17.2%
Operating expenses	(1,898)	(1,864)	1.8%
Operating profit before impairment/provisions on advances	2,986	2,304	29.6%
Loan impairment release/(charge) for bad and doubtful debts	85	(29)	NM
Profit before taxation	3,071	2,275	35.0%

  

	At 30 June 2005	At 31 December 2004	Increase/ (decrease)
Segment assets	136,206	132,790	2.6%
Segment liabilities	552,822	567,309	(2.6%)

Note: For additional segmental information, see Note 36 to the accounts.

NM: Not meaningful

### Results

Retail Banking recorded a growth in profit before taxation by 35.0% to HK\$3,071 million as compared to the first half in 2004, mainly due to an increase in net interest income.

Net interest income improved by 34.2% to HK\$3,656 million. Rising Hong Kong dollar interest rate and our efforts in managing funding cost directly contributed to a widening of deposit spread. This was partially offset by narrowing residential mortgage loan spread as Prime – HIBOR spread contracted substantially during the period.

Other operating income declined by 15.0% to HK\$1,228 million. Customers demanded investment products with higher potential returns as interest rate moved up. Increase in sales of structured products and open-ended investment funds by 87.4% and 12.0% respectively partially offset the drop from sales of capital guaranteed funds. Commissions from stockbroking were affected by a decline in market transaction volume. Income from foreign exchange also dropped amid a weaker US dollar and less volatile market conditions.

Advances and other accounts, including mortgage loans and card advances, increased by 6.8% to HK\$130,108 million from end-2004. Customer deposits decreased slightly by 2.0% to HK\$532,568 million.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Wealth management

Wealth management is one of the key strategic focuses of our Retail Banking activities. After launching Wealth Management Prime service in December 2004, the Group introduced the brand-new Wealth Management VIP service in January 2005, a professional and personalised wealth management service for customers with an asset position of HK\$2 million or above. By end of June 2005, the number of Wealth Management customers and assets under management grew by 30% and 23% respectively when compared to end-2004.

### Residential mortgage

A buoyant property market and effective marketing contributed to the strong growth in our mortgage business. The Group's mortgage loan balance increased by 8.2% to HK\$103,411 million from end-2004. The pricing competition in the market remained intense but as the Prime - HIBOR spread narrowed, banks began raising their pricing. During the period, the Group also raised the pricing of new mortgage loans and reduced cash rebate. Benefiting from the property price appreciation and improved credit risk management, the asset quality of mortgage loans continued to improve.

### Personal RMB banking business

The Group provides comprehensive personal RMB banking services. We recorded remarkable growth of 63.8% in RMB deposits to RMB8,438 million. The number of ATM that provides RMB withdrawal service also increased from 232 at end-2004 to 241. We also maintained our leading position in RMB credit card issuance. The total number of RMB cards issued increased by 23.3% from end-2004.

### Credit cards

Card business continued to expand in terms of customer base and service range. The Group's card business sustained its growth momentum in the first half of 2005. Card advances increased by 2.2% and the number of cards issued grew by 3.2% from end-2004. Cardholder spending volume and merchant acquiring volume registered double-digit growth of 20.4% and 21.5% respectively as compared to the first half of 2004.

The Group successfully launched China UnionPay merchant acquiring business in Thailand in January and introduced a new BOC credit card in Singapore with BOC Singapore. We launched new Visa SMS-based Bill Payment Service, which enables cardholders to pay bills via mobile phone, and MasterCard SecureCode, which provides secure and easy-to-use online payment and shopping services to cardholders. In May, we introduced the Two-factor Authentication Service, which provides more secure and convenient online services to our cardholders.

The Group's outstanding performance and service quality were duly recognised by the market. During the year, we won a number of awards from MasterCard International, The Hong Kong Trade Development Council and The International Licensing Industry Merchandisers:

- 2005 Gold prize of MasterCard Asia/Pacific Marketing Leadership Awards Best Program Launch
- 2005 Gold prize of MasterCard Asia/Pacific Marketing Leadership Awards Best Platinum Marketing
- 2005 Premier Asian Licensing Awards – Best Marketing Campaign in Hong Kong

### Corporate Banking

HK\$m, except percentage amounts	Half-year ended 30 June 2005	Half-year ended 30 June 2004	Increase/ (decrease)
Net interest income	1,768	1,779	(0.6%)
Other operating income	505	615	(17.9%)
Operating income	2,273	2,394	(5.1%)
Operating expenses	(506)	(521)	(2.9%)
Operating profit before impairment/provisions on advances	1,767	1,873	(5.7%)
Loan impairment release/write-back of bad and doubtful debts	1,350	1,269	6.4%
Profit before taxation	3,117	3,142	(0.8%)

  

	At 30 June 2005	At 31 December 2004	Increase/ (decrease)
Segment assets	208,645	187,947	11.0%
Segment liabilities	97,063	90,054	7.8%

Note: For additional segmental information, see Note 36 to the accounts.

#### Results

Corporate Banking reported a small decline in profit before taxation by 0.8% to HK\$3,117 million as compared to the first half of 2004.

Net interest income stayed flat. The benefit from widened deposit spread was offset by a narrower loan spread as keen market competition continued to exert pressure on the yield. Other operating income dropped by HK\$110 million mainly due to amortisation of directly attributable loan fees into interest income using the effective interest calculation upon the adoption of HKAS 39.

Loan impairment release amounted to HK\$1,350 million. Asset quality of our corporate loan portfolio continued to solidify as a result of an improving bad debt migration rate and higher collateral value. Recoveries remained strong amid favorable market conditions.

The Group achieved significant growth in loans and advances in the first half of 2005. Advances and other accounts increased by 8.9% to HK\$202,855 million from end-2004. Customer deposits increased by 7.9% to HK\$94,729 million.

#### Corporate and SMEs

Leveraging on the revitalised economy, Corporate Banking's business strategy is to grow small and medium-sized enterprises, and trade financing.

Despite intense pricing competition, we achieved a decent growth in trade financing and bills processing volume. In June, Factors Chain International, a global network of leading factoring companies, upgraded the Group's membership status from Associate Member to Full Member.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

A new product, SME Quick Loan was launched to cater for our SME customers. By the end of June 2005, the total amount of loans to SMEs increased by 9.1% to about HK\$48,815 million from end-2004.

Our Corporate Banking continued to maintain its leading position in the syndication loan market. The Group was ranked as the second largest arranger in the local syndicated market and the combined syndicated loan market of Hong Kong, China and Macau in the first half of 2005 by Basis Point, a leading Asian debt market magazine.

In March, we were appointed by the China Foreign Exchange Trade System as the clearing bank for Hong Kong dollar.

During the period, we improved our internal management mechanism, simplified workflow, and increased overall operational efficiency, with the ultimate goal of enhancing our product delivery and customer service quality. In June, a new credit management division within Corporate Banking was set up to enhance our SME business serving capability by improving credit analysis process and speeding up approval.

### Mainland branches

The rapidly expanding economy and enormous business potential in the Mainland market provides increasing opportunities for banks. Persistent efforts have been put to integrate the business operations of Retail Banking and Corporate Banking in Hong Kong with our Mainland network in order to capitalise on the Group's competitive edge.

In the first half of 2005, the Group's Mainland branches continued to expand our business. Loans and advances rose by 40.0% while operating profit before impairment grew by 94.5%.

During the period, Nanyang's Shenzhen branch was approved to extend its RMB services to domestic companies. Furthermore, nine branches have obtained permission to commence insurance agency business. To further broaden its range of products, the Group rolled out structured deposits in the Mainland. We have been preparing for the introduction of wealth management services and option-linked deposits since the second quarter of this year.

### Treasury

HK\$m, except percentage amounts	Half-year ended	Half-year ended	Increase/ (decrease)
	30 June 2005	30 June 2004	
Net interest income	568	1,014	(44.0%)
Other operating income	468	320	46.3%
Operating income	1,036	1,334	(22.3%)
Operating expenses	(198)	(177)	11.9%
Operating profit before impairment/provisions on advances	838	1,157	(27.6%)
Others	18	1	1,700.0%
Profit before taxation	856	1,158	(26.1%)

  

	At 30 June 2005	At 31 December 2004	Increase/ (decrease)
Segment assets	445,495	453,457	(1.8%)
Segment liabilities	84,140	68,485	22.9%

Note: For additional segmental information, see Note 36 to the accounts.

### Results

Treasury reported a profit of HK\$856 million, down 26.1% in the first half of 2005, mainly due to a decline in net interest income. Flattening yield curve with rising short-term interest rates squeezed the net interest income from managing residual funds. This was largely reflected in the large increase in interest expenses to Retail Banking and Corporate Banking for their deposit-taking business, partially offset by the increase in interest income from debt securities investments.

Increase in other operating income was mainly due to the gains in foreign exchange swap contracts, favorable changes in fair value of interest rate derivatives and other financial instruments.

### Investment portfolio management

The money market and capital market environments in the first half of 2005 were both encouraging and challenging. As the US Federal Reserve continued to raise interest rate, Treasury actively reallocated the Group's investment portfolio for better returns. Under an acceptable risk level, we further diversified our investment portfolios by investing in asset-backed debt securities and corporate bonds.

### Customer trades

The foreign exchange, precious metals and equity markets were less volatile than the same period last year. Customer investment sentiment was affected and this directly had a negative impact on the turnover of our customer-driven business.

Despite this, we put strong emphasis on developing tailor-made products and on exploring cross-selling opportunities in our Retail Banking and Corporate Banking. As a result, we have achieved great success in promoting retail structured deposits and this built a solid platform for offering other structured products in the future.

## Risk Management

### Overview

Risk management is vital to our corporate governance process. We believe that sound risk management is a key success factor of an organisation. As such, in our daily operational management, we emphasise that risk management is the foundation of healthy business development in achieving a balance between risk control and business growth. The principal types of risk inherent in the Group's business are reputation risk, legal and compliance risk, strategic risk, credit risk, market risk, interest rate risk, liquidity risk and operational risk. The Group's risk management objective is to enhance shareholder value, while maintaining risk exposures within acceptable limits.

### Risk Management Governance Structure

BOCHK's risk management governance structure is designed to cover the whole process of all businesses and ensure various risks are properly managed and controlled when carrying out business. BOCHK has a sound risk management organisational structure. Various groups of risk takers assume their respective responsibilities for risk management.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The Board of Directors, representing the interest of the shareholders, is the highest decision making authority and has the ultimate responsibility for risk management. The Board with the assistance of its sub-committees has the primary responsibility for the determination of risk management strategies, and ensures that BOCHK has established an effective risk management system to implement those risk management strategies. The Risk Committee ("RC"), established by the Board of Directors as a standing committee, is responsible for approving BOCHK's major risk management policies and procedures and major asset and liability management policies.

Management includes Chief Executive ("CE") and committees which have the responsibility to implement the policies and procedures and various risk limits in accordance with the risk management strategies set by the Board, and to oversee the effectiveness of managing and controlling risk in the day-to-day management. The Chief Risk Officer ("CRO") and the Chief Financial Officer ("CFO") assist the CE to manage various types of risks. The CRO oversees the operation of the Risk Management Department ("RMD"), Legal and Compliance Department ("LCD") and Special Asset Management Department ("SAMD") and is responsible for reputation risk, legal and compliance risk, credit risk, market risk and operational risk. The CFO oversees the operation of the Economics and Strategic Planning Department and Finance Department and is responsible for strategic risk, interest rate risk and liquidity risk.

BOCHK has comprehensive policies and procedures to identify, measure, monitor and control various risks across the organisation, to set appropriate risk limits, and to continually monitor these risks and limits by means of administrative procedures and information systems. BOCHK continually modifies and enhances its risk management policies and procedures to reflect changes in markets and business strategies.

BOCHK's principal banking subsidiaries, Nanyang and Chiyu, are managed consistently with the policies of the Group. These subsidiaries execute their risk management strategy independently and report to BOCHK's management on a regular basis.

### **Reputation Risk Management**

Reputation risk is the risk that negative publicity regarding BOCHK's business practices, whether genuine or not, will cause a potential decline in the customer base or lead to costly litigation or revenue erosion. Reputation risk is inherent in every aspect of our business operation and covers a wide spectrum of issues. Market rumors or public perceptions are significant factors in determining the level of risk in this category.

In order to mitigate reputation risk, BOCHK has formulated and implemented a Reputation Risk Management Policy. This policy establishes standards to prevent and to manage reputation risk proactively at an early stage. It requires constant monitoring of external reputation risk incidents and published failures of risk incidents within the financial industry. In order to eliminate or alleviate the negative impact on BOCHK's reputation, incidents related to reputation risk are handled promptly in accordance with the Emergency Contingency Plan and Special Reporting System for Special Incidents.

### **Legal and Compliance Risk Management**

Legal risk is the risk that unenforceable contracts, lawsuits or adverse judgments may disrupt or otherwise negatively affect the operations or financial condition of BOCHK. LCD is responsible for proactively identifying, assessing and managing legal risk faced by BOCHK in the ordinary course of its business.

Compliance risk is the risk of legal and regulatory sanctions, financial loss, or loss to reputation that BOCHK may suffer as a result of its failure to comply with all applicable laws, regulations, international practices, local trade standards, codes of conduct and standards of good practice. By establishing and maintaining appropriate policies and guidelines, LCD ensures that BOCHK conducts its business in compliance with the requirements of relevant laws and regulations.

### **Strategic Risk Management**

Strategic risk generally refers to the risks that may induce some current or future negative impacts on the earnings, capital, reputation or market position of BOCHK because of poor strategic decisions, improper implementation of strategies and lack of response to the market. BOCHK has developed its Strategic Risk Management Policy that defines the responsibilities of the Board and the Management when implementing its desired strategies.

### **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 BOCHK. Credit risk arises principally from BOCHK's lending, trade finance and treasury activities.

BOCHK follows different approval procedures for high-risk and low-risk loans.

Low-risk credit transactions that fulfill certain requirements relating to credit types, loan purposes, loan amounts, guarantees, collateral coverage and security adequacy can be processed using low-risk loan approval procedures. Under these procedures, authorised credit officers in credit initiation units may approve this type of credit application without prior review by the RMD. A loan review officer in the RMD conducts independent post-approval reviews of such pre-approved low-risk credit transactions and assesses 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 based on the review conclusions.

BOCHK has developed an application scorecard for personal unsecured credit facilities. The scorecard is used to analyse applicants' demographic and credit characteristics and to predict future repayment performance. With scorecards, credit decisions are made based on credit scoring results. Several other scorecards for different types of personal lending products are being developed.

For loans reaching the approval authority of Deputy Chief Executives ("DCE") or above, independent risk assessment by the Credit Risk Assessment Committee ("CRAC") is required. The CRAC is a specialised committee, which consists of experts from the lending and other areas of BOCHK. The CRAC is responsible for making independent risk assessment of significant credit applications. The decision of CRAC will be an important basis for the CRO, DCE and CE to make their credit decisions. The CRAC itself has no credit approval authority.

Loans that exceed the approval authority of CE have to be approved by the RC.

BOCHK conducts post-disbursement reviews to ensure compliance with established credit policies and procedures in the loan portfolio.

To improve loan quality, BOCHK has set up internal targets to control the amount of criticised loans. The RMD regularly reports loan quality to senior management for high-level oversight.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 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. BOCHK'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 the risk limits approved by the RC. The overall risk limits are divided into sub-limits by reference to different risk factors, including interest rate, foreign exchange rate, commodity price and equity price. 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.

Having set up the monitoring limits and supervisory procedures, the Market Risk Division in the RMD is responsible for the daily oversight of BOCHK's market risk to ensure that the overall and individual market risks are within BOCHK's risk tolerance.

VaR is a statistical technique which estimates the potential losses that could occur on risk positions taken due to movements in interest rates, foreign exchange rates, commodity prices and equity prices over a specified time horizon and to a given level of confidence. The model used by BOCHK to calculate portfolio and individual VaR on a variance/co-variance 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.

The following table set out the VaR for all trading market risk exposure of BOCHK.

HK\$'m	At 30 June 2005	Minimum for the first half of 2005	Maximum for the first half of 2005	Average for the first half of 2005
VaR for all market risk	2.8	1.7	4.7	2.9
VaR for foreign exchange risk	1.9	1.2	4.0	2.1
VaR for interest rate risk	2.1	1.6	3.7	2.5

HK\$'m	At 30 June 2004	Minimum for the first half of 2004	Maximum for the first half of 2004	Average for the first half of 2004
VaR for all market risk	2.2	0.9	5.6	3.3
VaR for foreign exchange risk	1.4	0.6	5.0	2.1
VaR for interest rate risk	1.8	0.5	4.4	2.6

For the first half of 2005, the average daily revenue of BOCHK earned from market risk related trading activities was HK\$2.2 million (first half of 2004: HK\$2.5 million). The standard deviation of these daily trading revenues was HK\$2.1 million (first half of 2004: HK\$2.5 million).

The most frequent result was a daily trading revenue of between HK\$1.0 million to HK\$3.0 million (first half of 2004: HK\$2.0 million to HK\$4.0 million). The highest daily revenue was HK\$11.0 million (first half of 2004: HK\$9.0 million).

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

### **Interest Rate Risk Management**

BOCHK's interest rate risk exposures mainly comprise structural positions. The major types of structural positions are:

- repricing risk – mismatches in the maturity or repricing periods of assets and liabilities
  
- basis risk – different pricing basis for different transactions so that yield on assets and cost of liabilities may change by different amounts within the same repricing period

BOCHK's Asset and Liability Management Committee ("ALCO") maintains oversight of interest rate risk and the RC sanctions the interest rate risk management policies formulated by the ALCO. The Finance Department carries out approved policies and develops systems and metrics to identify, measure and monitor interest rate risk.

Gap analysis is one of the tools used to measure BOCHK's exposure to interest rate risk. It provides BOCHK with a static view of the maturity and repricing characteristics of its balance sheet positions. The magnitude of the gaps indicates the extent to which BOCHK is exposed to the risk of potential changes in the margins on new or repriced assets and liabilities.

BOCHK uses interest rate derivatives to hedge its interest rate exposures and in most cases, plain vanilla interest rate swaps are used.

With respect to repricing risk, sensitivities of earnings and economic value to interest rate changes (Earnings at Risk and Economic value at Risk) are assessed through hypothetical interest rate shock of 200 basis points across the yield curve on both sides. Earnings at Risk and Economic value at Risk are respectively controlled within an approved percentage of the projected net interest income for the year and the latest capital base as sanctioned by the RC. The Finance Department reports the results to the ALCO and the RC on a regular basis.

The impact of basis risk is gauged by the projected change in net interest income under scenarios of imperfect correlation in the adjustment of the rates earned and paid on different instruments. Ratios of asset and liability of different pricing basis are set to monitor such risk.

Stress tests on repricing risk and basis risk are conducted regularly. The ALCO monitors the results of stress tests against limits and decides whether remedial action should be taken.

### **Liquidity Risk Management**

The goal of liquidity management is to enable BOCHK, even under adverse market conditions, to meet all its maturing repayment obligations on time and to fund all of its asset growth and strategic opportunities, without forced liquidation of its assets at short notice.

BOCHK funds its operations principally by accepting deposits from retail and corporate depositors. In addition, BOCHK may issue certificates of deposit to secure a long-term financing source or may raise funds through the sale of investments. BOCHK uses the majority of funds raised to extend loans, to purchase debt securities or to conduct interbank placements.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

BOCHK manages and measures its liquidity through maintaining strong liquidity ratios, examining the stability of depositors and the respective concentration risk, monitoring the loan to deposit ratio, maintaining a portfolio of high quality liquid securities and conducting regular stress tests. BOCHK also smoothens 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 BOCHK's asset and liability management strategy is to achieve optimal return while ensuring adequate levels of liquidity and capital within an effective risk control framework and at reasonable cost of funding. BOCHK's ALCO is responsible for establishing these policy directives (including the liquidity contingency plan), and the RC sanctions the liquidity management policies. The Finance Department closely monitors the liquidity risk of BOCHK and reports to the Management and ALCO regularly.

### **Operational Risk Management**

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events. BOCHK aims to manage this risk in line with the best practices of the industry.

BOCHK manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risks, and reviews the risks inherent in business processes, activities and products. BOCHK monitors operational risk profile, records operational risk data and reports to the RC and senior management. As part of our effective internal control environment, BOCHK establishes detailed internal policies and control

procedures, monitors transactions and conducts reconciliation of accounts regularly. BOCHK also emphasises the need for appropriate segregation of duties and independent authorisation in all business activities.

The Business Continuity Plan is in place to support business operations in the event of disasters. Adequate backup facilities are maintained and periodic drills are conducted. The Company also arranges insurance cover to reduce potential losses in respect of operational risk.

### **Stress Testing**

BOCHK supplements the analysis of various types of risks with stress testing. Stress testing is a risk management tool for estimating BOCHK's risk exposures under stressed conditions arising from extreme but plausible market or macroeconomic movements. These tests are conducted on a regular basis and the results are reported to the Board, the RC and the ALCO on a regular basis.

### **Capital Management**

The major objective of capital management is to maximise the return to shareholders while maintaining a strong capital position. BOCHK would consider the adjustment of capital mix when appropriate to achieve the lowest overall cost of capital. The existing capital base, while may be high relative to the market, is considered appropriate to support the future business expansion of the Group. The ALCO, with the assistance of the Finance Department, monitors the adequacy of BOCHK's capital using the capital adequacy ratio as one of the major measurements. The Group complied with all the statutory capital standards for all the periods presented in the report.