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中銀香港(控股)有限公司

BOC HONG KONG (HOLDINGS) LIMITED

(Incorporated in Hong Kong with limited liability under the Companies Ordinance)

(the “Company”)

ANNOUNCEMENT

REPORT OF THE SPECIAL COMMITTEE

on

**Corporate Governance, Credit Approval Process,
Risk Management and Internal Control Mechanisms
of**

Bank of China (Hong Kong) Limited

The Special Committee has completed its review of the corporate governance, credit approval process and risk management and internal control mechanisms of the Bank. The section entitled “Summary of findings and recommendations” from the Report of the Special Committee together with a “Statement by the Board on the Special Committee’s Report” are reproduced below, for information of shareholders and investors.

The full report of the Special Committee will be published and will also be posted on the Company’s website at www.bochkholdings.com.

Introduction

This announcement is made by the Company pursuant to paragraph 2 of the Listing Agreement.

As stated in the Company’s announcement dated 17th June, 2003, the remit of the Special Committee is “to review the credit approval, risk management and internal control processes of BOCHK, as well as the effectiveness of the high level controls exercised over these matters by the Board” including the circumstances surrounding the approval of the New Nongkai loan, and report to the Board through the Audit Committee. KPMG and Moores Rowland were also engaged to undertake a review on BOCHK under Section 59 of the Banking Ordinance.

Summary of findings and recommendations of the Special Committee

The Special Committee has completed its review of the corporate governance, credit approval process and risk management and internal control mechanisms of the Bank. The Section entitled “Summary of findings and recommendations” from the Report of the Special Committee is reproduced below for the information of shareholders and investors.

“The Committee submits the following findings and recommendations to the Board, through the Audit Committee:

(i) Current state of the New Nongkai loan (“the loan”)

- *The bridging loan was HK\$1.77 billion (which was the final amount drawn from a facility of HK\$2.107 billion), of which HK\$1.03 billion has been repaid, leaving HK\$740 million outstanding as at 30 June 2003;*
- *As collateral for the outstanding loan, the Bank has a first legal charge over 75% of the shares of Shanghai Land;*
- *Receivers have been appointed to Shanghai Land, and there is HK\$1.2 billion in a deposit in the name of the Receivers with the Bank. It is understood that the company has minor liabilities which could be applied against this deposit;*
- *The Special Committee is satisfied that active steps are being taken for recovery. The loan was assessed by Moores Rowland as part of their s.59 Review. They recommended that, as at 31 May 2003, a loan classification of “special mention” and, consistent with that, made no recommendation for a specific provision. However, the loan is currently classified by the Bank as “substandard”, and a specific provision of HK\$126 million has been made. PwC has concurred with this level of specific provision, included in the audited accounts for the six months ended 30 June 2003.*

(ii) Errors of judgment

- *The loan was granted according to the procedures and delegated authorities then applicable. Though large, it was not a loan which required Board approval, and therefore would not have come to the Board’s attention until circumstances so required eg were it to become non-performing;*

- *As far as we could determine, the procedures were followed, but in our opinion the judgments surrounding the making of the loan were faulty:*
 - *Although the risks were identified at the start, they were not adequately addressed in the following respects:*
 - *The Bank never obtained sufficient information on Mr. Chau to be able to know his net worth and assess its accessibility;*
 - *In order to be repaid, the Bank relied on payments to be made against asset injections to be arranged by Mr. Chau into Shanghai Land, which depended on his good faith and honesty, and on the ability of Mr. Chau and Shanghai Land to comply with Hong Kong Stock Exchange Listing Rules;*
 - *The Bank accommodated Mr. Chau's request not to take mortgage rights over properties available for injection into Shanghai Land, based on his representations that the injection of properties so mortgaged might be deemed as "connected transactions". The Bank was thereby put into the position of having to rely on Shanghai Land shares as collateral, coupled with complex and resource intensive loan administration arrangements to protect the value of these shares, by ensuring that there was no dissipation of Shanghai Land's assets or accumulation of liabilities. This further increased reliance on Mr. Chau's good faith and honesty, since no foolproof protection system could be devised;*
 - *The bank officials involved in processing the loan showed lack of sensitivity to issues involved in compliance with the Listing Rules. Although the onus was on Mr. Chau through his professional intermediaries to do so, and bank officials did make it an express condition in the loan documentation that Mr. Chau should comply, there was always a risk that there would be public speculation that the Bank may have facilitated the evasion of the Listing Rules, whether or not there was evasion. Because of client confidentiality, the Bank would find it difficult to defend itself in public.*
 - *The Bank was thereby exposed to both credit and reputational risk disproportionate to the rewards deriving from the loan;*
 - *The loan having been made, its subsequent management has been satisfactory, although costly. It has been intensively monitored by management, and as the loan was performing until Mr. Chau's disappearance and the appointment of Receivers to Shanghai Land, there was no cause for the Board to become involved until that stage.*

(iii) Who was responsible

- *On the evidence available to the Special Committee, it found no cause to believe that the officials involved in the loan were motivated by anything other than what they saw as the Bank's best interests. It notes that Mr. Chau made an effort to deliver according to the terms of the loan, and did repay a substantial portion of it. Indeed, if the Extraordinary General Meeting of Shanghai Land, called for 3 June 2003 but then postponed, had approved the proposed further asset injection, only a very small amount of the loan would remain outstanding. Current recovery action indicates a possibility that the Bank may make substantial recovery perhaps with little or no loss to the Bank;*
- *Notwithstanding this, prudent banking practice requires the exercise of good judgment at the beginning, Mr. Chau has disappeared, and the Bank's reputation has been damaged by the adverse publicity surrounding the loan. Having considered the Moores Rowland Report and conducted its own independent inquiries, the Special Committee makes the following criticisms of the two most senior bank officials involved, in descending order of responsibility:*
 - *Mr. Liu Jinbao (former Chief Executive) failed to intervene in the transaction although he knew there were serious reservations, which had not been satisfied. He should have appreciated that Mr. Or's position as de facto Chairman of the Credit Committee would impede its effectiveness when dealing with a loan proposal which Mr. Or advocated, such as the New Nongkai loan;*
 - *Mr. Or Man Ah (Deputy Chief Executive for Corporate Banking) advocated the loan without having sufficient regard to the risks inherent in the transaction and the concerns of the Risk Management Department.*

(iv) Actions taken or to be taken immediately

- *The Credit Committee approval procedure is being replaced by a new procedure, centered on a new Credit Assessment Committee, addressing the imbalance between business generation and risk management and the inherent conflict of interest in the old system;*
- *The Special Committee recommends that the Board accepts Mr. Or's application for retirement bearing in mind his service record, which but for the lapse of judgment in this instance, has been a distinguished one. His ready acceptance of responsibility shows commendable sense of personal accountability that is entirely consistent with the high regard he is held by his colleagues;*
- *The Special Committee recommends that the Board address a note of its findings to BOC for Mr. Liu's role in the loan.*

(v) Building stronger foundations

- *Based on its review of the KPMG and Moores Rowland findings and its own, independent observations, the Special Committee is fully satisfied with the continuing integrity of the credit approval, risk management and internal control processes of the Bank. Following the merger from 12 predecessor banks, the Bank has been pursuing a steady program of implementation of the risk management and internal controls processes described in the Prospectus at its IPO and in its last Annual Report. The comprehensive review undertaken in the last three months of the Bank's credit approval, risk management and internal controls processes in the corporate banking business of the Bank shows that the Bank is on track with this program, but the Review has also given the Bank an opportunity to take stock of progress and to consider enhancements to these processes. This review has also afforded the bank an opportunity to take stock of its corporate governance against increasingly high expectations globally and consider improvements to meet these expectations;*
- *KPMG have identified a number of detailed deviations of Bank credit and risk management practice from the Bank's own policies and HKMA guidelines. Most of the variations relate to the Bank's own policies, and the Committee notes that the HKMA guidelines are expressed at a high level. The Special Committee is satisfied that the deviations from both internal policies and HKMA guidelines are not serious but should nonetheless be rectified as soon as possible, against a timetable agreed with HKMA, monitored by Internal Audit, reporting to the Audit Committee;*
- *Further detailed enhancements to risk management, credit approval and internal control processes have been identified by KPMG as desirable even though HKMA guidelines are met. Management should take these forward, subject to Board oversight;*
- *KPMG have similarly suggested detailed enhancements to the high level controls in place even though HKMA guidelines are met. The Special Committee likewise believes that the Chief Executive should take those forward by formulating detailed proposals to the Board in the manner set out in the section of this Report dealing with Corporate Governance;*
- *In this Report, the Special Committee wishes to highlight to the Board the areas of enhancements in processes and high level controls that will most benefit the Bank.*

(vi) Enhancing management structure

- *The Special Committee is satisfied that the present organizational and management structure has served the bank well, but drawing from the KPMG review, its own observations as well as discussions with the Chief Executive, believe that further enhancement of the existing organizational and management structure will benefit the Bank;*

- *Recognition of the importance of risk management, which is underlined by the lessons learnt from the New Nongkai Loan, should be enhanced. This could be done by elevating the position of Chief Risk Officer in seniority to rank alongside the heads of business generation, as Director of Risk. He will report directly to the Chief Executive and to the Board. His duty would be to ensure the Bank continues to maintain best international practice in credit, market, operational, legal and compliance risk control. This will require the position to be filled by a world class candidate, through competition open to inside and outside applicants;*
- *A new position of Chief Operating Officer should be established. His remit would be to help the Chief Executive co-ordinate and implement the many change programs now underway in the Bank, together with the enhancements proposed as part of this Review, and thereby deliver an operational capability for the Bank which meets best international practice. He will report directly to the Chief Executive and to the Board, and should rank alongside the existing Deputy Chief Executives. This will require the position to be filled by a world class candidate, through competition open to inside and outside applicants;*
- *In order that the Bank may achieve its ambition to become a first class international bank, the Chief Executive will need the full support of the Board to allow him the resources required to accomplish this. Not only will the Chief Executive need to recruit the best candidates for the two senior positions identified here by the Special Committee, he will have to design in conjunction with the Board, bank wide human resource and remuneration policies, which will be conducive to identifying and retaining the best candidates for all key positions in the bank;*
- *The Special Committee notes that the right human resource and remuneration policies need not increase overall cost but should aim at paying the right persons the right compensation and staffing the bank at a level which is supported by the business generated.*

(vii) Enhancing corporate governance

- *Though they have reported that the high level controls within the bank meet HKMA guidelines, KPMG have made a number of suggestions and recommendations about the Board committee structure, nominations, agenda management, self-assessment, and other matters of corporate governance. The Special Committee notes that all of these recommendations are broadly in line with thinking already underway within the Board and therefore deserve to be implemented, but some command more priority than others;*
- *The most immediate priority relates to independent non-executive directors, following Mr. Chia's retirement. His replacement should have experience which would ideally include one or more of the fields of corporate governance, change management, project management, and banking related risk management. In*

order to gain the desired spread within the experience spectrum just mentioned, possibly more independent non executive directors should be appointed;

- *KPMG's has suggested the setting up of an Executive Committee and the appointment of additional executive directors. This recommendation deserves careful study. The Board should task the Chief Executive to conduct a study of the need and feasibility of an executive committee and if thought fit, to include detailed proposals in a report to the Board, within 6 months, bearing in mind the need for the Chief Executive to first attend to the enhancement of the management structure;*
- *The Special Committee recommends that Compliance (which is presently overseen by a Sub-Committee of the Audit Committee and comprised of Bank executives and a co-opted member from BOC) should be recognized as part of the risk management function of the Bank, and so recommends that the Board's Risk Management Committee should also become responsible for Compliance and the Risk Management Committee should immediately ask the Chief Executive to review whether he is satisfied that there is sufficient capability in the Legal & Compliance Department to provide compliance support to securities markets issues encountered in the Bank's lending transactions;*
- *The Board should task the Audit Committee to commission a more detailed review of the internal audit process against international banking best practice, to ensure that the Internal Audit function delivers the highest possible added value in addition to complying with best international practice;*
- *The Chief Executive should be tasked to assess KPMG's other detailed suggestions for their value in promoting operational efficiency and effectiveness of the Board, reporting to the Board within 3 months.*

(viii) Conclusion — reaching for higher standards

- *The making of the loan occurred soon after the Bank's creation from the merger of its predecessor banks, in the early stages of implementing its new risk management systems. The Special Committee believes that the key issue is a "people" issue since the key issue identified in the New Nongkai Loan is not failure of the risk management system but a lapse in judgment in a particular instance. Systems can be put in place but they are operated by people. So, it is essential to embed the values and principles of risk management already adopted and described in the Bank's 2002 Annual Report (on pages 124 and 125), at the management and operational levels of the Bank. The Bank has embarked upon this by the many projects brought underway since the merger and staff and management have been engaged at multiple levels. A new awareness is taking hold. The Review has enabled us to stand back, take stock and see how we might undertake this change better;*

- *The priority is to ensure that the Bank has an enhanced top management team to support the Chief Executive and in this respect, it is important to select, as soon as possible, the new Chief Operating Officer and Director of Risk. These should be persons with sufficient experience to bring international best practice into the Bank, and with the right qualities to bring forward the ambitious program of change that the Bank has already committed to undertake in its merger plans. The recruitment of a world class candidate to replace Mr. Or in the position of Deputy Chief Executive (Corporate Banking) will further enhance the Bank's top management team. The next priority is to make sure that the Bank has the human resource and compensation policies which are conducive to ensuring that the best candidates are placed and retained in all key positions in the Bank. Only then, can the Bank truly aspire to be a Bank which is capable of operating under best international practice;*
- *Board leadership will play a critical role in the effort to achieve best international practice. The Chief Executive should be given the fullest support by the Board to motivate the staff to implement the change program already under way, which this Review seeks to enhance. It is only through the joint effort of the Board, the management and the staff that the Bank may emerge as a stronger institution, ready to reach for higher standards."*

Statement by the Board on the Special Committee's Report

The Board met today to consider the Report of the Special Committee it established on 10th June 2003. The Statement by the Board on the Special Committee's Report is reproduced as follows :

"Since our restructuring and merger on an unprecedented scale in October 2001 and our public listing last year, we have been going through a rigorous process of transformation, during which we have strived to harmonize various systems and upgrade our standards, thus paving the way for BOCHK to become a first class international bank. To realize synergies generated by the restructuring and merger to improve operational efficiencies, we have been closely following the principles and practices of good corporate governance, which we firmly believe to be essential ingredients for BOCHK as a leading banking corporation and for Hong Kong as an international financial and commercial centre.

The New Nongkai episode was unfortunate. We regret that this episode stifled the incremental progress that we were achieving across all our operations. However, as an accountable and responsible company, we are determined to take immediate and proactive measures to ensure we remain on track with our transformation. At the same time, we recognize the importance of restoring public confidence and rebuilding our image in both the local and international arenas.

In response to the Special Committee's findings and recommendations, the Board met this morning and decided on the following:

1. ***The Board notes that the Special Committee is satisfied with the continuing integrity of the credit approval, risk management and internal control processes of the Bank but wishes to make use of the opportunity to enhance the Bank's management and corporate governance structure. Accordingly, Management has been instructed:***
 - (i) *To rectify the deviations of Bank policies from the Hong Kong Monetary Authority's guidelines identified by KPMG, against a timetable agreed with HKMA. Progress will be monitored by the Audit Committee and reported to the Board on a quarterly basis; and*
 - (ii) *To take forward the further enhancements in credit and risk management and internal control processes recommended by KPMG. It will produce an implementation plan and timetable, which should recognise that some enhancements are more urgent or easier to introduce than others. Management will be expected to make a quarterly report to the Board, and justify the reasons for not implementing any recommendations which it disagrees with.*
2. *The Board has tasked the Audit Committee to commission a more detailed review of the internal audit process in the Bank against international banking best practice, to ensure that the Internal Audit function delivers the highest possible added value in addition to complying with best international practice.*
3. *The Board has accepted the Special Committee's recommendation, which it notes is supported by the Chief Executive, that a Chief Operating Officer and Director of Risk should be appointed. The Board has decided that these posts should be filled by suitable world-class candidates, either from inside the Bank or outside, including the wider Bank of China Group. It has tasked the Chief Executive with managing a competitive selection process on the Board's behalf, prior to Board approval of the selected candidates. **In approving the recruitment of the two posts of Chief Operating Officer and Director of Risk, the Board wishes to make it clear that this does not imply any criticism or should in any way reflect adversely on the staff performing similar functions within the Bank.***
4. *The Board wishes to increase the number of independent non-executive directors. It endorses the Special Committee's view as to what would be useful experience at present. It has identified a candidate who will be appointed to replace Mr. Chia Pei-yuan who retired in July as soon as regulatory clearance is obtained and has also short-listed a few more potential candidates.*
5. *To enable the Board and its other committees to focus more on strategy and oversight of the business, and improve communication between the Board and Management, the Board has tasked the Chief Executive to conduct a study of the need and feasibility of an executive committee of the Board.*

6. *The Board has considered the criticisms made by the Special Committee of Mr. Liu Jinbao and Mr. Or Man Ah and accepts the Special Committee's findings. As Mr. Liu Jinbao is no longer working for the Bank, the Board will address a note of the findings of the Special Committee to the Bank of China. Mr. Or has applied for early retirement, and the Board has decided to accept his application, in view of his long service and previous contribution to the Bank. The Board wishes to place on record that Mr. Or readily accepted responsibility. This is a commendable display of a strong sense of personal accountability to the Bank that is entirely consistent with the high regard held by his colleagues for him. The Bank wishes him a happy retirement.*

*The Board believes that the work of the Special Committee has brought the episode to a close. The Bank should now continue to forge ahead with breaking new grounds and growing its business while progressing towards achieving its aim to become a first class international bank. **The Board would like to put it on record that the staff has been very understanding, committed and supportive during the Bank's restructuring and merger exercise and has remained so during this difficult period.** Together we have come through the New Nongkai episode, the SARS crisis and its economic ramifications as a stronger and better organization. We would like to thank our staff for their good work. The Board also wishes to express its gratitude to the Special Committee and everybody involved for their energy, commitment, and wise counsel."*

Report of the Special Committee

To ensure that the market and the shareholders do receive full information on the findings and recommendations of the Special Committee, the Board has decided to publish the full Report. Summaries of the findings of Moores Rowland and KPMG are attached as Appendices 3 and 4 respectively to the Report. A copy of the Report including the Appendices (in both English and Chinese) will be sent together with the Group's 2003 Interim Report and Audited Accounts to members of the Company. The Report is also available (in both English and Chinese) on the Company's website at www.bochkholdings.com. In case of queries about how to obtain copies of the Report or how to access the Report on the Company's website, please call the Company's hotline at (852) 2846 2700.

Definitions

Unless the context requires otherwise, the following words have the meanings set out below :

"Board" means the Board of Directors of the Company;

"BOC" means Bank of China, the ultimate holding company of the Company;

“BOCHK” or “Bank”	means Bank of China (Hong Kong) Limited, the principal operating subsidiary of the Company and an authorised institution under the Banking Ordinance;
“Chau”	means Mr. Chau Ching Ngai;
“Group”	means the Company and its subsidiaries;
“HKMA”	means the Hong Kong Monetary Authority;
“New Nongkai Loan”	means the loan advanced by BOCHK to New Nongkai Global Investments Limited for the purpose of financing the latter’s acquisition of equity interest in Shanghai Land;
“PwC”	means PricewaterhouseCoopers, the auditors of the Group;
“Shanghai Land”	means Shanghai Land Holdings Limited, a company listed on the Stock Exchange of Hong Kong Limited.

By order of the Board
Jason CW Yeung
Company Secretary

Hong Kong, 5th September, 2003