

2001

Financial Disclosure Statement



中國銀行(香港)有限公司
BANK OF CHINA (HONG KONG) LIMITED

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The directors of Bank of China (Hong Kong) Limited announce that the audited results of the Bank and its subsidiaries (hereinafter referred to as the "Group") for the year ended 31 December 2001 are as follows:

(A) CONSOLIDATED PROFIT AND LOSS ACCOUNT

	<u>Note</u>	<u>2001</u> HK\$m	<u>2000</u> HK\$m (restated)
Interest income		38,307	55,449
Interest expense		<u>(23,320)</u>	<u>(39,403)</u>
Net interest income		14,987	16,046
Other operating income	(C) 2	<u>4,022</u>	<u>4,652</u>
Operating income		19,009	20,698
Operating expenses	(C) 3	<u>(5,847)</u>	<u>(5,568)</u>
Operating profit before provisions		13,162	15,130
Charge for bad and doubtful debts	(C) 4	<u>(7,412)</u>	<u>(8,593)</u>
Operating profit after provisions		5,750	6,537
Restructuring costs	(C) 5	(937)	-
Net (loss)/gain on disposal/revaluation of fixed assets	(C) 6	(1,237)	90
Net gain on disposal of held-to-maturity securities and investment securities		20	43
Write-back of provision/(provision) for impairment in held-to-maturity securities and investment securities		24	(62)
Gain on disposal of subsidiaries		12	-
Gain/(loss) on disposal of associates/provision for impairment in associates		20	(16)
Share of net profits/(losses) of associates		<u>81</u>	<u>(50)</u>
Profit before taxation		3,733	6,542
Taxation		<u>(832)</u>	<u>(1,178)</u>
Profit after taxation		2,901	5,364
Minority interests		<u>(133)</u>	<u>(151)</u>
Profit attributable to shareholders		<u><u>2,768</u></u>	<u><u>5,213</u></u>

(B) CONSOLIDATED BALANCE SHEET

	<u>Note</u>	<u>2001</u> HK\$'m	<u>2000</u> HK\$'m (restated)
Assets			
Cash and short-term funds		196,255	255,248
Placements with banks and other financial institutions			
maturing between one and twelve months		80,773	108,414
Trade bills		382	539
Certificates of deposit held		19,474	25,673
Hong Kong SAR Government certificates of indebtedness		25,510	22,370
Held-to-maturity securities	(C) 7	50,988	48,326
Investment securities		44	313
Other investments in securities	(C) 8	56,169	33,890
Advances and other accounts	(C) 9	308,108	325,569
Investments in associates		416	742
Fixed assets		21,049	10,571
Other assets		<u>6,972</u>	<u>7,715</u>
Total assets		<u><u>766,140</u></u>	<u><u>839,370</u></u>
Liabilities			
Hong Kong SAR currency notes in circulation		25,510	22,370
Deposits and balances of banks and other financial institutions		55,295	129,766
Current, fixed, savings and other deposits from customers		606,428	624,726
Certificates of deposit issued		5,000	9,000
Other accounts and provisions		<u>20,671</u>	<u>18,631</u>
Total liabilities		<u><u>712,904</u></u>	<u><u>804,493</u></u>
Capital Resources			
Minority interests		-- <u>1,066</u>	-- <u>1,532</u>
Share capital	(C) 10	43,043	43,043
Reserves	(C) 11	<u>9,127</u>	<u>(9,698)</u>
Shareholders' funds		<u><u>52,170</u></u>	<u><u>33,345</u></u>
Total liabilities and capital resources		<u><u>766,140</u></u>	<u><u>839,370</u></u>

(C) SELECTED NOTES TO THE ACCOUNTS

(1) Group Reorganisation And Basis Of Preparation

Bank of China (Hong Kong) Limited (the "Bank") is incorporated in Hong Kong and controlled by the Bank of China, a state-owned commercial bank established under the laws of the People's Republic of China.

In 2001, BOC reorganised its banking operations in Hong Kong Special Administrative Region ("Hong Kong" or "HKSAR") by merging all its directly and indirectly controlled banking and related financial operations in Hong Kong into the Bank on 1 October 2001 (the "Reorganisation"). The name of the Bank was changed from Po Sang Bank Limited to Bank of China (Hong Kong) Limited on the same date. All of the operations involved in the Reorganisation had been in existence prior to 1 January 2000.

The Reorganisation is governed by a Merger Agreement dated 31 May 2001 and a Supplemental Agreement dated 30 September 2001 entered into between Bank of China and certain of its directly or indirectly controlled entities with banking and related financial operations in Hong Kong. It was also accomplished using a private members' bill, which was passed by the Hong Kong Legislative Council on 12 July 2001 and became law on 20 July 2001. In addition, by the Legal Tender Notes Issue Ordinance (Amendment of Schedule) Notice 2001, the Bank replaced Bank of China as a bank note issuing bank in Hong Kong.

The Reorganisation represents a business combination resulting from transactions among enterprises under the common control of Bank of China. Under the principles of merger accounting, the consolidated financial statements of the Group are prepared as if the Group structure as at 1 October 2001 had been in existence from the beginning of 2000. Therefore the comparative figures for 2000 have been restated accordingly.

(C) SELECTED NOTES TO THE ACCOUNTS (Continued)

(2) Other Operating Income

	<u>2001</u>	<u>2000</u>
	HK\$m	HK\$m
Fees and commission income	3,585	3,974
Less: Fees and commission expenses	<u>(889)</u>	<u>(972)</u>
Net fees and commission income	2,696	3,002
Dividend income from investments in securities		
- listed investments	1	2
- unlisted investments	65	40
Net gain on other investments in securities	108	130
Net gain from foreign exchange activities	816	845
Net gain from other dealing activities	8	19
Data and cheque processing service income	74	104
Gross rental income from investment properties	177	125
Others	<u>77</u>	<u>385</u>
	<u>4,022</u>	<u>4,652</u>

(3) Operating Expenses

	<u>2001</u>	<u>2000</u>
	HK\$m	HK\$m
Staff costs (including directors' emoluments)	3,796	3,357
Premises and equipment expense excluding depreciation		
- rental of premises	297	307
- others	335	359
Depreciation		
- owned fixed assets	460	514
Other operating expenses	<u>959</u>	<u>1,031</u>
	<u>5,847</u>	<u>5,568</u>

(C) SELECTED NOTES TO THE ACCOUNTS *(Continued)*

(4) Charge For Bad And Doubtful Debts

	<u>2001</u> HK\$m	<u>2000</u> HK\$m
Net charge for bad and doubtful debts		
Specific provisions		
- new provisions	10,649	7,583
- releases	(645)	(296)
- recoveries	<u>(530)</u>	<u>(99)</u>
	9,474	7,188
General provisions	<u>(2,062)</u>	<u>1,405</u>
Net charge to consolidated profit and loss account	<u><u>7,412</u></u>	<u><u>8,593</u></u>

(5) Restructuring Costs

Restructuring costs are direct expenditure arising from the Reorganisation of the Group. Details of the restructuring costs are as follows:

	<u>2001</u> HK\$m
Stamp duty levied on immovable properties	584
Stamp duty levied on shares	64
Severance payments	112
Legal and professional fees	39
Others	<u>138</u>
	<u><u>937</u></u>

There were no restructuring costs for the year ended 31 December 2000.

(6) Net (Loss)/Gain On Disposal/Revaluation Of Fixed Assets

	<u>2001</u> HK\$m	<u>2000</u> HK\$m
Net gain on disposal of fixed assets	4	90
Net loss on revaluation of fixed assets	<u>(1,241)</u>	<u>-</u>
	<u><u>(1,237)</u></u>	<u><u>90</u></u>

(C) SELECTED NOTES TO THE ACCOUNTS (Continued)

(7) Held-To-Maturity Securities

	<u>2001</u>	<u>2000</u>
	HK\$m	HK\$m
Unlisted, at amortised cost	34,592	39,260
Less: Provision for impairment in value	<u>(42)</u>	<u>(9)</u>
	<u>34,550</u>	<u>39,251</u>
Listed, at amortised cost	<u>16,438</u>	<u>9,131</u>
Less: Provision for impairment in value	<u>-</u>	<u>(56)</u>
	16,438	9,075
Total	<u>50,988</u>	<u>48,326</u>
Listed, at amortised cost		
- In Hong Kong	2,239	1,363
- Overseas	<u>14,199</u>	<u>7,712</u>
	<u>16,438</u>	<u>9,075</u>
Market value of listed investments	<u>15,905</u>	<u>9,110</u>

Held-to-maturity securities are analysed by issuer as follows:

	<u>2001</u>	<u>2000</u>
	HK\$m	HK\$m
Central governments and central banks	3,470	5,169
Public sector entities	17,722	5,476
Banks and other financial institutions	24,454	32,669
Corporate entities	<u>5,342</u>	<u>5,012</u>
	<u>50,988</u>	<u>48,326</u>

(C) SELECTED NOTES TO THE ACCOUNTS (Continued)

(8) Other Investments In Securities

	<u>2001</u> HK\$m	<u>2000</u> HK\$m
Debt securities		
Unlisted, at fair value	50,973	32,519
Listed, at fair value		
- In Hong Kong	294	194
- Overseas	<u>4,812</u>	<u>1,059</u>
	<u>56,079</u>	<u>33,772</u>
Equity securities		
Unlisted, at fair value	62	77
Listed, at fair value		
- In Hong Kong	28	35
- Overseas	<u>-</u>	<u>6</u>
	<u>90</u>	<u>118</u>
Total	<u>56,169</u>	<u>33,890</u>

Other investments in securities are analysed by issuer as follows:

	<u>2001</u> HK\$m	<u>2000</u> HK\$m
Central governments and central banks	1,495	2,677
Public sector entities	24,557	2,539
Banks and other financial institutions	28,876	27,509
Corporate entities	<u>1,241</u>	<u>1,165</u>
	<u>56,169</u>	<u>33,890</u>

(C) SELECTED NOTES TO THE ACCOUNTS (Continued)

(9) Advances And Other Accounts

	<u>2001</u>	<u>2000</u>
	HK\$m	HK\$m
Advances to customers	323,038	340,039
Accrued interest	<u>2,180</u>	<u>5,028</u>
	<u><u>325,218</u></u>	<u><u>345,067</u></u>
Provision for bad and doubtful debts		
- General	(6,538)	(8,624)
- Specific	<u>(10,576)</u>	<u>(10,972)</u>
	<u><u>(17,114)</u></u>	<u><u>(19,596)</u></u>
	<u><u>308,104</u></u>	<u><u>325,471</u></u>
Advances to banks and other financial institutions	<u>4</u>	<u>98</u>
	<u><u>308,108</u></u>	<u><u>325,569</u></u>

Non-performing loans are analysed as follows:

	<u>2001</u>	<u>2000</u>
	HK\$m	HK\$m
Non-performing loans	<u>35,512</u>	<u>34,649</u>
Specific provisions made in respect of such advances	<u>10,322</u>	<u>10,442</u>
As a percentage of total advances to customers	<u>10.99%</u>	<u>10.19%</u>
Amount of interest in suspense	<u>610</u>	<u>763</u>

Non-performing loans are defined as loans and advances to customers on which interest is being placed in suspense or on which interest accrual has ceased. The specific provisions were made after taking into account the value of collateral in respect of such advances.

There were no advances to banks and other financial institutions on which interest has been placed in suspense or on which interest accrual has ceased as at 31 December 2001 (2000: nil) nor were there any specific provisions made in respect of advances to banks and other financial institutions (2000: nil).

(C) SELECTED NOTES TO THE ACCOUNTS (Continued)

(10) Share Capital

	<u>Ordinary shares of HK\$1 each</u>	
	Number of shares (in million)	HK\$m
Authorised:		
As at 1 January 2001	4	400
Increase due to share split	396	-
Increase pursuant to Reorganisation during the year	<u>99,600</u>	<u>99,600</u>
As at 31 December 2001	<u>100,000</u>	<u>100,000</u>

	<u>Ordinary shares of HK\$1 each</u>	
	Number of shares (in million)	HK\$m
Issued and fully paid:		
As at 1 January 2001	4	400
Increase due to share split	396	-
Increase pursuant to Reorganisation during the year	<u>42,643</u>	<u>42,643</u>
As at 31 December 2001	<u>43,043</u>	<u>43,043</u>

The share capital issued by the Bank as part of the Reorganisation has been treated as if it was issued from the beginning of 2000 as presented in the consolidated accounts.

(C) SELECTED NOTES TO THE ACCOUNTS (Continued)

(11) Reserves

	Merger reserve (Note ii) HK\$m	Premises revaluation reserves HK\$m	Investment property revaluation reserves HK\$m	Translation reserve HK\$m	Retained earnings HK\$m	Total HK\$m
As at 1 January 2000	(41,252)	-	-	(10)	29,225	(12,037)
Profit for the year	-	-	-	-	5,213	5,213
Exchange differences	-	-	-	3	-	3
1999 final dividends paid	-	-	-	-	(438)	(438)
2000 interim dividends paid	-	-	-	-	(420)	(420)
Remittance of profits by Merging Branches (Note i)	-	-	-	-	(2,171)	(2,171)
Capital contributions from ultimate holding company	-	-	-	-	152	152
As at 31 December 2000	<u>(41,252)</u>	<u>-</u>	<u>-</u>	<u>(7)</u>	<u>31,561</u>	<u>(9,698)</u>
As at 1 January 2001	(41,252)	-	-	(7)	31,561	(9,698)
Profit for the year	-	-	-	-	2,768	2,768
Exchange differences	-	-	-	(2)	-	(2)
2000 final dividends paid	-	-	-	-	(40)	(40)
2000 other final dividends paid	-	-	-	-	(502)	(502)
Remittance of profits by Merging Branches (Note i)	-	-	-	-	(3,034)	(3,034)
Capital contributions from ultimate holding company	-	-	-	-	8,068	8,068
Revaluation of properties	-	8,408	3,159	-	-	11,567
Capitalisation of reserves	<u>41,252</u>	<u>(7,952)</u>	<u>(3,119)</u>	<u>-</u>	<u>(30,181)</u>	<u>-</u>
As at 31 December 2001	<u>-</u>	<u>456</u>	<u>40</u>	<u>(9)</u>	<u>8,640</u>	<u>9,127</u>

Note:

- (i) "Merging Branches" comprise Bank of China - Hong Kong Branch, Kincheng Banking Corporation - Hong Kong Branch, Kwangtung Provincial Bank - Hong Kong Branch, Sin Hua Bank Limited - Hong Kong Branch, The China State Bank, Limited - Hong Kong Branch, The China & South Sea Bank Limited - Hong Kong Branch, The National Commercial Bank Limited - Hong Kong Branch, The Yien Yieh Commercial Bank Limited - Hong Kong Branch, Kwangtung Provincial Bank - Shenzhen Branch, and Sin Hua Bank Limited - Shenzhen Branch.
- (ii) The merger reserve represents the difference between the nominal value of shares recorded as share capital issued by the Bank on 1 October 2001 plus any additional consideration in the form of cash or other assets and the nominal value of share capital recorded for all of the subsidiaries acquired pursuant to the Reorganisation. As a result of the Reorganisation, the reserves of the Merging Branches, Hua Chiao Commercial Bank Limited and the subsidiaries acquired pursuant to the Reorganisation were effectively capitalised by the Group on 1 October 2001.

(C) SELECTED NOTES TO THE ACCOUNTS *(Continued)*

(12) 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:

	<u>2001</u>	<u>2000</u>
	HK\$m	HK\$m
Direct credit substitutes	1,967	5,515
Transaction-related contingencies	2,273	3,528
Trade-related contingencies	16,391	22,088
Other commitments		
- under 1 year or which are unconditionally cancellable	84,497	86,072
- 1 year and over	43,879	24,733
Forward forward deposits placed	11,872	6,988
Others	<u>88</u>	<u>115</u>
	<u>160,967</u>	<u>149,039</u>

(C) SELECTED NOTES TO THE ACCOUNTS (Continued)

(12) Off Balance Sheet Exposures (Continued)

(b) Derivatives

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

	2001			2000		
	Trading HK\$m	Hedging HK\$m	Total HK\$m	Trading HK\$m	Hedging HK\$m	Total HK\$m
Exchange rate contracts						
Spot	18,766	-	18,766	41,629	-	41,629
Forward and futures	3,224	-	3,224	22,825	-	22,825
Swaps	124,585	4,688	129,273	139,351	3,573	142,924
Options purchased	2,195	-	2,195	706	-	706
Options written	19,850	-	19,850	2,628	-	2,628
Interest rate contracts						
Swaps	60	10,088	10,148	516	6,379	6,895
Forward rate agreements	1,280	-	1,280	-	-	-
Bullion contracts	<u>545</u>	<u>-</u>	<u>545</u>	<u>446</u>	<u>-</u>	<u>446</u>

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:

	2001		2000	
	Replacement cost HK\$m	Credit risk weighted amount HK\$m	Replacement cost HK\$m	Credit risk weighted amount HK\$m
Contingent liabilities and commitments	-	29,490	-	22,388
Exchange rate contracts	457	407	791	534
Interest rate contracts	99	37	204	48
Bullion contracts	<u>6</u>	<u>5</u>	<u>3</u>	<u>3</u>
	<u>562</u>	<u>29,939</u>	<u>998</u>	<u>22,973</u>

The contractual or notional amounts of these instruments indicate the volume of transactions outstanding as at the balance sheet date; they do not represent 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 Hong Kong Monetary Authority ("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.

(D) UNAUDITED SUPPLEMENTARY FINANCIAL INFORMATION

(1) Overdue And Rescheduled Advances

(a) Overdue and non-performing advances to customers

	2001		2000	
	HK\$m	% of total advances to customers	HK\$m	% of total advances to customers
Gross advances overdue for				
- 6 months or less but over 3 months	4,212	1.30%	3,960	1.16%
- 1 year or less but over 6 months	5,427	1.68%	7,030	2.07%
- Over 1 year	<u>15,659</u>	<u>4.85%</u>	<u>18,233</u>	<u>5.36%</u>
Advances overdue for more than 3 months	25,298	7.83%	29,223	8.59%
Less: Amount overdue for more than 3 months and on which interest is still being accrued	(1,786)	(0.55%)	(2,488)	(0.73%)
Add: Amount overdue 3 months or less and on which interest is being placed in suspense or on which interest accruals has ceased				
- included in rescheduled advances	1,315	0.41%	4,006	1.18%
- others	<u>10,685</u>	<u>3.30%</u>	<u>3,908</u>	<u>1.15%</u>
Gross non-performing advances	<u><u>35,512</u></u>	<u><u>10.99%</u></u>	<u><u>34,649</u></u>	<u><u>10.19%</u></u>

(D) UNAUDITED SUPPLEMENTARY FINANCIAL INFORMATION *(Continued)*

(1) Overdue And Rescheduled Advances *(Continued)*

(b) Rescheduled advances to customers

	2001		2000	
	HK\$m	% of total advances to customers	HK\$m	% of total advances to customers
Rescheduled advances	<u>1,814</u>	<u>0.56%</u>	<u>6,809</u>	<u>2.00%</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.

(D) UNAUDITED SUPPLEMENTARY FINANCIAL INFORMATION (Continued)

(2) Segmental Information

(a) Sectoral analysis of advances to customers

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

	<u>2001</u> HK\$m	<u>2000</u> HK\$m
Loans for use in Hong Kong		
Industrial, commercial and financial		
- Property development	28,300	26,129
- Property investment	47,758	54,571
- Financial concerns	7,314	7,765
- Stockbrokers	108	97
- Wholesale and retail trade	24,091	29,558
- Manufacturing	11,477	14,581
- Transport and transport equipment	8,778	5,886
- Others	51,054	49,278
Individuals		
- Loans for the purchase of flats in the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Schemes	20,273	13,291
- Loans for the purchase of other residential properties	82,513	84,729
- Credit card advances	3,019	2,699
- Others	9,735	14,598
Trade finance	<u>10,487</u>	<u>14,386</u>
Total loans for use in Hong Kong	<u><u>304,907</u></u>	<u><u>317,568</u></u>
Loans for use outside Hong Kong		
Industrial, commercial and financial		
- Property development	2,176	2,759
- Property investment	1,427	1,280
- Financial concerns	489	593
- Wholesale and retail trade	331	578
- Manufacturing	1,656	2,605
- Transport and transport equipment	2,418	3,482
- Others	8,430	9,045
Individuals		
- Loans for the purchase of other residential properties	824	1,214
- Others	301	846
Trade finance	<u>79</u>	<u>69</u>
Total loans for use outside Hong Kong	<u><u>18,131</u></u>	<u><u>22,471</u></u>
	<u><u>323,038</u></u>	<u><u>340,039</u></u>

(D) UNAUDITED SUPPLEMENTARY FINANCIAL INFORMATION *(Continued)*

(2) Segmental Information *(Continued)*

(b) Analysis of advances to customers by geographical areas:

	<u>2001</u>	<u>2000</u>
	HK\$m	HK\$m
Hong Kong	310,953	321,340
Mainland China	7,753	11,103
Others	<u>4,332</u>	<u>7,596</u>
	<u>323,038</u>	<u>340,039</u>

(c) Analysis of advances overdue for more than 3 months by geographical areas:

	<u>2001</u>	<u>2000</u>
	HK\$m	HK\$m
Hong Kong	21,713	23,578
Mainland China	3,465	4,725
Others	<u>120</u>	<u>920</u>
	<u>25,298</u>	<u>29,223</u>

(d) Analysis of non-performing advances by geographical areas:

	<u>2001</u>	<u>2000</u>
	HK\$m	HK\$m
Hong Kong	30,043	28,020
Mainland China	5,130	5,614
Others	<u>339</u>	<u>1,015</u>
	<u>35,512</u>	<u>34,649</u>

(D) UNAUDITED SUPPLEMENTARY FINANCIAL INFORMATION (Continued)

(3) Capital Base And Capital Adequacy Ratio

	<u>2001</u>
Capital adequacy ratio as at 31 December	<u>14.38%</u>
Adjusted capital adequacy ratio incorporating market risk exposure as at 31 December	<u>14.57%</u>

The unadjusted capital adequacy ratio is computed on the consolidated basis which comprises the positions of the Bank and eighteen subsidiaries, including Nanyang Commercial Bank, Limited ("Nanyang"), Chiyu Banking Corporation Limited ("Chiyu"), and BOC Credit Card (International) Limited, its three principal operating subsidiaries, as required by the HKMA for its regulatory purposes, and is in accordance with the Third Schedule of the Banking Ordinance.

The adjusted capital adequacy ratio 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 capital adequacy ratio.

Details of the consolidated capital base of the Bank as at 31 December 2001 are as follows:

	<u>2001</u> HK\$m
Core capital:	
Paid up ordinary share capital	43,043
Reserves	<u>9,541</u>
Total core capital	52,584
Eligible supplementary capital:	
General provisions for bad and doubtful debts	<u>4,943</u>
Total capital base before deductions	57,527
Deductions from total capital base	<u>(979)</u>
Total capital base after deductions	<u>56,548</u>

The 2000 comparative capital adequacy ratio and capital base are not meaningful in light of the Reorganisation and hence are not presented.

(D) UNAUDITED SUPPLEMENTARY FINANCIAL INFORMATION (Continued)

(4) Liquidity Ratio

Average liquidity ratio	<u>2001</u> <u>39.88%</u>
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The average liquidity ratio 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 Reorganisation) to 31 December 2001.

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

The average liquidity ratios for periods prior to the Reorganisation are not comparable and hence are not presented.

(D) **UNAUDITED SUPPLEMENTARY FINANCIAL INFORMATION** *(Continued)*

(5) **Risk Management**

Overview

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 return on capital while maintaining risk exposure within acceptable parameters.

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 has established, in connection with its reorganisation, a more centralised, independent and comprehensive risk management structure that involves the following elements:

- a standardised corporate 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");
- 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's principal banking subsidiaries, Nanyang and Chiyu, 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.

(D) **UNAUDITED SUPPLEMENTARY FINANCIAL INFORMATION** *(Continued)*

(5) **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 return on capital 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 risk management committee, has set the Group's overall risk management strategy and policies, and the Group's overall risk limits and credit authorisation guidelines. The risk management committee 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, fair and comprehensive manner;
- emphasising the importance of cash flow as an essential factor in assessing applicants' repayment ability;
- complying with legal and regulatory requirements;
- 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;
- providing an accurate measurement and full disclosure of credit risk exposure; and
- maintaining a consistent credit policy

(D) **UNAUDITED SUPPLEMENTARY FINANCIAL INFORMATION** *(Continued)*

(5) **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 is managed within risk limits approved by the risk management committee. 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 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 Risk Management Department ("RMD") is responsible for the management of market risk and reports to the risk management committee and the Chief Executive. Through the daily risk monitoring process, the RMD 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.

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 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 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 maintains a portfolio of liquid and high quality securities that are managed by the Bank's Treasurer. 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.

(E) SUMMARY OF CHIEF EXECUTIVE'S REPORT

The year 2001 witnessed a new milestone for the Bank of China in Hong Kong. During the year, the restructuring and merger of 12 commercial banks of the former Bank of China Group in Hong Kong was accomplished, leading to the establishment of the Bank of China (Hong Kong) Limited ("the Bank") on 1 October 2001. The merger is no doubt the largest scale of its kind in the local banking industry ever recorded in Hong Kong.

Through the restructuring and merger, the Bank has formed new organisational structures, defined new development strategies and established new management concepts and systems in order to enhance our operations in line with leading market practices. In particular, the Bank has made the following achievements:

1. The Bank has established a sound corporate governance mechanism. In compliance with the requirements of the locally incorporated banks in Hong Kong, we have established an enhanced Board of Directors system (including the appointment of independent directors) that clearly defines the accountability and responsibilities of the Board and the management. Our policy-making mechanism and process have been standardized, clarified and become more efficient to enable the operating mechanism function effectively.
2. The Bank has formulated a clear development strategy. We aim to develop into an integrated, return-on-equity driven financial institution by enhancing our core competency in Hong Kong and the global market place in order to maximize shareholder value. To meet this target, we have duly allocated resources, formulated and implemented our business strategies.
3. A unified brand name, a centralized product development capacity and an extensive distribution network have enhanced the Bank's marketing capability, driving the traditional service-oriented culture towards a more proactive sales-oriented one.
4. The Bank has adopted various independent risk management and control mechanisms. By implementing our new and centralized risk management policies, mechanisms and procedures, we have enhanced the effectiveness of risk control, creating favourable conditions for the improvement of our asset quality.
5. After the integrated and re-engineering of the back office, we have introduced standardized operational processes and procedures into the Bank, moving towards integrated and systematic operations. A number of automated and electronic systems and workflow of the back office are now in the process of being set up. All these have allowed us to fully capitalize on the advantages and effectiveness of our back-office centralization.

As the global economy has not yet fully recovered, the local economy is only expected to achieve slight growth in 2002. Needless to say, the banking industry will continue to face tough times. We will focus on the core tasks of business development and strive to accelerate our business growth by capitalising on the strengths and opportunities arising from our restructuring and merger. By leveraging our broad customer base and extensive distribution network, together with a more in-depth understanding of our customers' needs, we will further enhance our quality financial services offered to our target customers. We will also fully exploit the opportunities brought by the further opening of the financial and banking markets in the Mainland of China after its accession to the World Trade Organisation. This will, on the one hand, help expand our mainland business while broadening our development opportunities in Hong Kong on the other hand.

The Bank of China (Hong Kong) Limited is a bank with new vision, new governance mechanisms and new operating models. We are committed to providing innovative and quality financial services to all our customers, locally and abroad. We strongly believe that with our strengthened corporate governance and risk management systems, the synergies resulting from our restructuring and merger will become more explicit. Our asset quality will also continue to improve. We will therefore be able to maximize our shareholder value while achieving our goal of becoming a leading international bank in the region.

(F) FINANCIAL OVERVIEW

Consolidated profit and loss account

The Group recorded a consolidated profit attributable to shareholders of HK\$2,768 million in 2001, a decrease of HK\$2,445 million or 46.90% compared with 2000. A fall in operating income, the occurrence of restructuring expenses and a loss on revaluation of fixed assets impacted adversely on the Group's results.

Operating profit

In 2001, operating profit before provisions was HK\$13,162 million, a decrease of HK\$1,968 million or 13.01% from 2000. In particular, net interest income was HK\$14,987 million, a decrease of HK\$1,059 million from 2000, and other operating income was HK\$4,022 million, a decrease of HK\$630 million from 2000. The decline in net interest income was mainly due to decreased return from cost-free funds resulting from the drastic fall in market interest rates during the year as well as the narrowing of net interest margin. The fall in bills transaction volume and stock market's turnover both adversely affected the related fees and commission income.

Operating expenses

Operating expenses in 2001 amounted to HK\$5,847 million, an increase of HK\$279 million or 5.01%. Staff costs, which represented the largest component of operating expenses, (i.e. 64.92% of total operating expenses), increased by HK\$439 million or 13.08% to HK\$3,796 million in 2001. This was mainly due to a general salary increase for all employees in 2001 as well as overtime payments relating to the work performed by the employees in connection with the restructuring and merger.

In 2001, premises and equipment expense (excluding depreciation) accounted for 10.81% of total operating expenses. This item decreased by HK\$34 million (or 5.11%) to HK\$632 million mainly due to lower premises rental expenses. Furthermore, depreciation and other operating expenses decreased by HK\$126 million (or 8.16%) to HK\$1,419 million.

As a consequence of the decline in operating income coupled with an increase in operating expenses, the cost to income ratio increased from 26.90% in 2000 to 30.76% in 2001, which was still low compared to our peers.

Charge for bad and doubtful debts

During the year, management has conducted comprehensive reviews of the asset quality of its loan book. As a result, additional specific provisions of HK\$10,649 million were made in 2001 (2000: HK\$7,583 million). Together with the release of general provisions and specific provisions due to improved quality of certain loans, the net charge for bad and doubtful debts in 2001 was HK\$7,412 million, HK\$1,181 million or 13.74% less than that in 2000. The decrease also reflected the strengthening of the Bank's loan recovery function which brought in a total recovery of HK\$530 million, an increase of HK\$431 million from that recorded in 2000.

(F) **FINANCIAL OVERVIEW** *(Continued)*

Non-operating expenses

Pursuant to the Group Reorganisation in 2001, the Group recorded a total of HK\$937 million of restructuring costs, mainly for legal and professional fees, stamp duty levied on shares and immovable properties, redundancies and other related restructuring costs. In 2001, the Group has changed its accounting policy on premises and investment properties from being stated at cost less depreciation to valuation. This resulted in a net loss on revaluation of fixed assets of HK\$1,241 million.

Consolidated balance sheet

Placements with banks and other financial institutions and investments in securities

After the merger, the Group had an opportunity to manage its liquidity and short term surplus funds collectively through a centralized asset and liability management function. This was previously managed on an individual entity basis for the sister banks of the Group in Hong Kong. As a result of the merger, the Group repatriated of approximately HK\$60 billion interbank balances with Bank of China. In addition, the Group has adjusted its investment strategy and increased its investment in securities that could generate more favourable yield. Certificates of deposit held, held-to-maturity securities, investment securities and other investments in securities as at 31 December 2001 amounted to HK\$126,675 million, 16.53% of total assets, and the total balance increased by HK\$18,473 million from HK\$108,202 million as at 31 December 2000, an increase of 17.07%.

Loans and advances to customers

The credit market in Hong Kong remained sluggish due to the weak economy. Advances and other accounts (net of provisions for bad and doubtful debt) decreased by HK\$17,461 million (or 5.36%) to HK\$308,108 million as at 31 December 2001 as compared to the previous year. The Group has applied a more rigorous risk management policy on credit extension, together with the bad debts written off amounted to HK\$10,435 million, the gross balances of advances to customers recorded a decrease of HK\$17,001 million in previous year.

After the merger, the Bank has established the Risk Management Department (“RMD”) and the Special Assets Management Department (“SAMD”). The RMD ensures adequate independent oversight and control over credit risk. It also enforces an appropriate credit administration and prudent procedures for approving credits. These changes have resulted in an improvement in asset quality. The SAMD has strengthened the monitoring and clean-up of non-performing loans. In particular, advances overdue for more than 3 months amounted to HK\$25,298 million as at 31 December 2001, a decrease of HK\$3,925 million from 2000, and the percentage to total advances to customers decreased from 8.59% to 7.83%, a decrease of 0.76%.

In June 2002, the Bank disposed of loans with a gross book value of HK\$11,401 million net of specific provisions of HK\$2,679 million to Bank of China Grand Cayman Branch.

(F) **FINANCIAL OVERVIEW** *(Continued)*

Provision for bad and doubtful debts

The Group has maintained an adequate provisioning level for bad and doubtful debts in accordance with the guidelines set by the HKMA. The total provision for bad and doubtful debts for advances to customers as at 31 December 2001 was HK\$17,114 million, representing 5.30% of total gross advances to customers.

Deposits and balances of banks and other financial institutions

Deposits and balances of banks and other financial institutions as at 31 December 2001 were HK\$55,295 million, a decrease of HK\$74,471 million, or 57.39% from 31 December 2000. The decrease was mainly due to reduction of deposits and balances with Bank of China.

Current, fixed, savings and other deposits from customers / Certificates of deposit issued

Following the deregulation of interest rates in Hong Kong from 3 July 2001, the Group has introduced a tiered deposit pricing system and has re-aligned part of the service fees with a view to better adapt to continuously changing market conditions in the banking industry, and improve the customer segmentation.

Following the restructuring and Reorganisation of the Group in 2001, in order to ensure the stability of our customer base and to maintain the high quality services to our customers, the Group made immense efforts to smoothen the transition and integration of its operations. During 2001, the tightening of the interest rate gap between fixed deposits and savings accounts has resulted in fixed deposits funds being re-invested in the more liquid savings accounts. Further, through the Group's strategy to manage the Group's funding more actively, there was a decrease in large deposits with high interest rates. This not only lowered the Group's funding costs but also reduced the Group's reliance on certain large depositors.

Overall, deposit balances decreased by HK\$18,298 million to HK\$606,428 million as at 31 December 2001, a decrease of 2.93%, slightly less than the local industry average.

During the year, the Group redeemed HK\$4,000 million of certificates of deposit issued.

Share capital and reserves

As at 31 December 2001, the Group's shareholders' funds increased from HK\$33,345 million in 2000 to HK\$52,170 million, comprising issued and fully paid share capital of HK\$43,043 million and reserves of HK\$9,127 million. During the restructuring, the Group's capital base was strengthened by the capital contributions from Bank of China and the revaluation of properties.