

CHIEF EXECUTIVE'S REPORT



HE Guangbei

*Vice Chairman and Chief Executive,
BOC Hong Kong (Holdings) Limited and
Bank of China (Hong Kong) Limited*

The past year was full of opportunities and challenges. With the Board's guidance and the joint effort of the Management and staff, we succeeded in implementing a pragmatic expansionary business strategy in pursuit of growth and excellence and overcoming the key challenges we faced, including a major management crisis.

On the back of Hong Kong's economic upturn and capitalising on its own foundations and strengths, the Group was able to deliver the highest profit attributable to shareholders and total annual dividend since its IPO in 2002. As well, the Group was able to expand most of its core businesses in 2004. Of equal, if not greater, importance is that we have also established a solid platform for business development during the year through the implementation of a number of new initiatives relating to development strategy, business model, risk management, and corporate culture.

In August 2004 we had to face an internal crisis that cropped up from an investigation by the Mainland Authorities concerning two former deputy chief executives of the Company. Nevertheless, the Board and the Management succeeded in resolving this crisis expeditiously and effectively and we could march on again full steam and re-focus on business development in almost no time. The transparent and timely approach we took in handling the issue helped keep the possible impact on the Group's image and reputation to a minimum. At the same time, we turned the crisis into an opportunity to further enhance our corporate governance and management structure so that the Group could keep moving on to realise its vision to be the premier bank for customers.

The other key challenge is one that all banks in Hong Kong had to face. Despite the economic recovery, the operating environment for banks remained tough in 2004 due to the persistently low HIBOR and fierce competition in the market. The extremely liquid HKD interbank market in the second half of the year due largely to speculative activities on RMB also depleted the return on HKD money market investments. To counter these unfavourable market conditions – at least partially – we focused on actively re-structuring our investment portfolio in accordance with the prudent risk management policies and parameters of the Group. Our effort in this area has paid off.

Performance Highlights

For the year ended 31 December 2004, the Group's profit attributable to shareholders reached a record high of HK\$11,963 million, up 50.23%. Earnings per share were HK\$1.1315, up 50.23%. The return on average total assets increased by 0.48 percentage point to 1.56% whereas the return on average shareholders' funds rose by 4.96 percentage points to 18.58%.

The rise in the Group's profit attributable to shareholders was due mainly to net provision write-back, gains on property revaluation and growth in non-interest



income from fees and commissions generated by the high-margin wealth management segment. Moreover, disciplined cost control further reduced the Group's operating expenses.

The Group's total operating income decreased by 8.09% to HK\$15,857 million, which was due partly to a 13.06% reduction in net interest income, caused primarily by the low HIBOR and squeezed margin. Non-interest income, however, increased by 6.51% to HK\$4,664 million, representing 29.41% of total income. In addition to the external environment, the management crisis in August inevitably had some undesirable impact on the implementation of the various initiatives regarding our business strategies and models, and hence, the Group's operating income. Now that the crisis is behind us, we are confident that the positive effects

of those initiatives would gradually manifest themselves and be reflected in the performance of the Group in the course of time.

The Group's operating expenses fell by 2.70% to HK\$5,505 million as operational efficiency and productivity continued to improve, partially offsetting the decrease in operating income. During the year, the Group's cost to income ratio was maintained at the low level of 34.72%.

With improved market conditions as well as effective risk management, the Group's overall asset quality improved substantially in 2004. Both the NPL ratio and classified loan ratio dropped to 2.95%, down 2.83 and 2.87 percentage points respectively. At the same time, the quality of our residential mortgage loans and card advances also improved. These achievements

reflected our commitment to de-risking our loan portfolio in certain industry sectors with an enhanced risk management culture and system that is now strictly observed throughout the Group in its daily operation.

Review of Business Performance

Despite the challenges and an increasingly competitive environment, 2004 was a year of new initiatives and achievements for the Group.

In terms of business performance, we made progress in a number of important areas in 2004. Firstly, we succeeded in enlarging our deposit and lending portfolio while maintaining our edge in traditional businesses. Deposits from customers increased by HK\$30,688 million, or 5.11%. Advances to customers continued to drop in the first half of 2004 as a result of write-offs and collection. However, we saw growth again in the second half with our renewed effort in sales and marketing in both Hong Kong and the Mainland. As a result, total advances to customers grew by 1.50% for the year. An even better measurement would be the growth in our performing loans, which grew by 4.55%. We also continued to diversify our loan portfolio by aggressively growing our retail lending and the loan portfolio of our Mainland branches.

The year under review also witnessed our success in maintaining our leading position in

traditional business. For example, we remained a leading arranger of syndicated loans in Hong Kong. We also remained the market leader in underwriting new residential mortgages. Our mortgage balance grew by 6.24% from end-2003. Our credit card business recorded outstanding performance. Compared to 2003, our cardholder spending and card issuance grew by 31% and 34% respectively. Card advances increased by 13.31%. Of equal importance, our charge-off and delinquency ratios fell to 3.96% and 0.38% respectively – well below the market average.

Secondly, with the momentum we built up in 2003, we recorded robust growth in the high-margin businesses in 2004, particularly wealth management and consumer credit, which partially compensated the fall in net interest income. Basically, the targets for most of the various components of our wealth management business were met or exceeded. The total wealth management income registered a strong growth of 27.91%.

Thirdly, since the introduction of personal RMB banking services in Hong Kong in early 2004, we have impeccably discharged our duty as the sole local clearing bank. We also pioneered the offering of premier RMB services, including personal deposits, exchange, remittance and bank cards, and have remained the local market leader by a large margin. We were the first issuer of RMB credit cards in Hong Kong with over 50,000

RMB cards issued by end-2004. In addition, we took the lead in launching UnionPay Card Payment Service in Hong Kong in January, and have enjoyed a leading position in the market.

Fourthly, our China-related business experienced healthy growth as we made use of our solid foundation to strengthen our presence in the Mainland market. Total advances to customers rose by 53% while customer deposits grew by 17%. The combined operating profit of our Mainland branches before provision increased by nearly 22%. More importantly, we not only succeeded in growing our loan portfolio and profit in the Mainland, but also managed to improve our asset quality substantially, with the classified

loan ratio dropping to 3.26% at end-2004, compared to over 10.35% a year ago.

The performance of our China-related business was the result of an effective business model that leverages the Group's retail and corporate franchise in Hong Kong, branch network in the Mainland and close cooperations with BOC to offer highly efficient and timely cross-border services to customers.

Last but not least, in July, in collaboration with BOCI Asia, Merrill Lynch and HSBC, the Group became the Arrangers and Joint Global Coordinators for the HKSAR Government's HK\$20-billion global bond offering. This was a significant breakthrough for the Group in a new arena of business.



Business Development Initiatives

With respect to the Group's business development, our focus in 2004 covered four main areas: (a) development strategy; (b) business model; (c) risk management; and (d) corporate culture.

Development strategy

In 2004, we continued to enhance our business development strategy to give it more clarity and make it more instructive for all business units. The effort we made in this respect was reflected in our success in maintaining our market leadership in areas we excel at, including the arrangement of syndicated loans, underwriting new residential mortgages and RMB banking.

We have finalised a new three-year business plan and related budgetary targets for the Group. These would guide us in further upgrading our business structure by enhancing the existing service platform for high-yielding businesses, including wealth management and asset management. At the same time, we have also been more proactive in growing and diversifying our customer base with more emphasis on the mid-market segment. This would help us diversify risks and generate new business. Our targets for RMB-related business in the short, medium and long terms would ensure our continued market leadership.

In 2004, we continued implementing a plan for further

strengthening our extensive branch network in Hong Kong, with a view to optimising its value for marketing and selling wealth management products. For the same purpose, we also enhanced our online banking channels.

Business model

During the year, we initiated a series of reforms in our major business models, with a view to improving our operational efficiency and competitiveness.

We refined our corporate banking business model to make it even more customer-focused. In July 2004, we piloted a new programme of corporate relationship management and product development whereby the corporate relationship managers and product managers would work closely, with the support of our middle office and back office units, to anticipate and fulfill individual customers' needs. This new approach has been working very satisfactorily so far and we are confident that it will enable us to identify and capture new business opportunities. At the same time, we have re-defined our customer and industry segmentation so that we can understand and assess customers' needs more accurately. We have also re-organised our sales force to specialise in different industries and serve customers better.

The implementation of our China-related business model was progressing as planned. Through





the joint effort of our people in both the Mainland and Hong Kong, we have come a long way in aligning our Mainland business with our Hong Kong headquarters in terms of development strategy, risk management, financial management and so on. It is expected that the operation of our China-related business model would be fully implemented within 2005.

At the same time, we also strove to strengthen the coordination and cooperation of departments involved in product development, resulting in the introduction of a broad range of new products and services during the year.

Risk management

Risk management remains one of our top strategic priorities. The Board and the Management have been working closely to ensure that we have a comprehensive, independent and effective system for managing risks. Our achievement in this area is reflected in the significant improvement we have made in recent years with

regard to our NPL ratio, which has dropped from 10.99% at end-2001 to 2.95% by end-2004, far exceeding our medium-term target.

Our risk management system is under constant review to take into account changes in internal and external circumstances. In 2004, we conducted a comprehensive review and developed the crucial policy documents for all the key types of risk. These documents have been approved by the Board and are now in force. The recent appointment of a new Chief Risk Officer will serve to further strengthen the Group's risk management function.

In anticipation of the New Capital Accord released by the Basel Committee (Basel II), we have formulated an implementation plan and set up a steering committee to prepare the Group for the implementation. We have also stepped up our effort in studying risk management at the macro level, with a view to assuming a more proactive role in this area.

During the year, we carried out a number of measures to enhance our compliance culture and system, and also strengthened the role of the Legal and Compliance Department in coordinating and supporting the other departments.

We are pleased to announce that the Tian Xing Jian Project introduced in 2003 to upgrade our corporate governance, risk management, credit approval and internal control mechanisms has been substantially completed. The completion of the Project represents an important milestone for the Company and serves as the foundation on which we can continue to reinforce our corporate governance to attain even higher standards of excellence.

The Group's corporate culture

After careful formulation and thorough bank-wide discussion, the Board approved the Group's Vision, Mission and Core Values (VMV), the bedrock of our corporate culture, in 2004.

Our **Vision** is to be customer's premier bank.

Our **Mission** is to **Build** customer satisfaction, **Offer** rewarding career opportunities to the staff and **Create** superior return to shareholders.

Our **Core Values** – **SPIRIT** in short and carrying equal importance – are **Social responsibility, Performance, Innovation, Respect, Integrity and Teamwork.**

To encourage our staff to identify with the VMV and in order that the VMV can be properly inculcated, embraced and perpetuated within the Group, we have developed and introduced a comprehensive communication and promotion programme among the staff. This effort will continue well into 2005. With our colleagues' unanimous support and cooperation, I am confident that we can develop a corporate culture that best suits the Group and gives us clear guidance as we move forward in the 21st century.



To ensure that the whole Group is working towards common goals, we started implementing a new performance appraisal system based on key performance indicators ("KPI"). The new KPI system embraces five main categories – profitability, asset quality and risk, the development of strategic business, operational efficiency, and manpower and innovation.

Prospects and Strategies

The economic recovery that Hong Kong is experiencing seems likely to extend into 2005 and benefit more business sectors. This should give rise to higher demand for loans as well as banking and financial services, though competition in the sector would remain intense.

The enhanced management structure that is now in place and the corporate reforms that were carried out in the past year will give the Group an edge in competing for new business, sustaining revenue

and profit growth and excelling itself in key areas in the coming year.

With our achievements in 2004, we will continue to perfect our development strategy, business model, corporate culture and risk management. Our primary objective is to achieve higher top line growth and ensure better return for shareholders.

We will continue to expand and diversify our income base. We will strive to raise our net interest margin by developing high-margin products. We will optimise our income structure by growing our non-interest income, and at the same time taking advantage of the rise in interest rates to grow our net interest income. We will also step up our effort in expanding our Mainland business. Internally, we will continue to enhance our human and technological capabilities as well as improve our operational efficiency and productivity.

For retail banking, we will leverage our product innovation, customisation, relationship building and cross-selling capabilities to ensure the growth momentum is maintained. We will continue to grow our wealth management products, credit card business and personal lending. We are also determined to maintain our leadership in residential mortgage business by offering competitive and flexible products.

For corporate banking, we have the benefit of a newly developed customer relationship building platform that enables us to explore and satisfy customers' diverse needs and capture untapped potential. We will also actively develop the SME business. These will facilitate us in developing and selling trade finance and high-margin products. At the same time, we will focus on further improving the asset quality of our corporate loan portfolio.

To drive the development of our SME business, which we consider an important part of our strategy, we have appointed a segment manager to oversee the SME segment and leverage our branch network to improve SME customers' access to customised services. Portfolio management of small exposures will be adopted to improve efficiency without sacrificing our prudent management of risks.

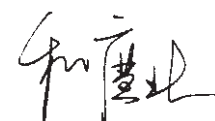
With immensely rich potential, the Mainland market will remain one of our major business focuses in the coming year. With the momentum we have

gained last year in growing our income and profit in this market, we will continue to leverage our branch network in both Hong Kong and the Mainland as well as our cooperation with BOC to expand our customer base and generate new business. At the same time, I am also confident that our capabilities and experience will ensure our leadership in the RMB banking business.

Vote of Thanks

I wish to thank the Board of Directors and the Senior Adviser for their guidance and support

throughout the year. I also thank all my colleagues for their loyalty, dedication and hard work. I am sure that together we can overcome any new challenges and achieve even greater success in the coming year.



HE Guangbei

*Vice Chairman and
Chief Executive*

Hong Kong, 23 March 2005



Senior management team of the Group: Mr HE Guangbei, Chief Executive (centre), Mr LAM Yim Nam, Deputy Chief Executive (2nd from left), Mr LEE Raymond Wing Hung, Chief Financial Officer (2nd from right), Mr GAO Yingxin, Deputy Chief Executive (1st from left), Mr CHEUNG Alex Yau Shing, Chief Risk Officer (1st from right)

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