

## MANAGEMENT'S DISCUSSION AND ANALYSIS

In this section, an analysis of the performance, financial position and risk management of the Group is provided. The following discussion is based on, and should be read in conjunction with, the accounts and the notes included in this Annual Report.

### Performance Measurement

In 2004, the Group made significant achievements in meeting its financial targets.

Financial Indicators	Targets	Performance	Result Highlights
ROE <sup>1</sup> and ROA <sup>2</sup>	Enhance ROE and ROA	<ul style="list-style-type: none"> <li>Profit attributable to shareholders increased by 50.23% to HK\$11,963 million, the second consecutive year of double-digit growth since IPO.</li> <li>ROE increased to 18.58% from 13.62% in 2003.</li> <li>ROA rose to 1.56% from 1.08% in 2003.</li> </ul>	<ul style="list-style-type: none"> <li><b>ROE: 18.58%</b></li> <li><b>ROA: 1.56%</b></li> </ul>
Dividend payout ratio	60-70%	The proposed final dividend plus interim dividend payout ratio was 63.19%.	<ul style="list-style-type: none"> <li><b>Dividend payout ratio: 63.19%</b></li> </ul>
Interest margin and non-interest income <sup>3</sup>	<ul style="list-style-type: none"> <li>Improve net interest margin</li> <li>Grow non-interest income</li> </ul>	<ul style="list-style-type: none"> <li>Net interest margin dropped to 1.55% from 1.82% in 2003, mainly due to decline in net interest spread under the low interest rate environment and keen market competition.</li> <li>Non-interest income increased, driven by strong wealth management business performance. Non-interest income to total operating income ratio increased by 4.03 percentage points to 29.41%.</li> <li>Growth in wealth management business mainly came from increase in distribution of life insurance products, investment funds, bonds and stockbroking.</li> </ul>	<ul style="list-style-type: none"> <li><b>Net interest margin: 1.55%</b></li> <li><b>Non-interest income to total operating income: 29.41%</b></li> </ul>
Cost efficiency	Maintain low cost to income ratio	Operating expenses decreased by 2.70%. Cost to income ratio was up 1.93 percentage points to 34.72% from 2003 mainly due to decline in total operating income.	<ul style="list-style-type: none"> <li><b>Cost to income ratio: 34.72%</b></li> </ul>
Asset quality	Reduce NPL ratio and classified loan ratio <sup>4</sup> to market levels in medium-term	NPL formation sustained at a low level. NPL ratio and classified loan ratio fell significantly. Classified loan ratio would have dropped to market level if not for the larger amount of legacy loss graded loans.	<ul style="list-style-type: none"> <li><b>NPL ratio: 2.95%</b></li> <li><b>Classified loan ratio: 2.95%</b></li> </ul>
Capital strength and liquidity	Maintain prudent capital and liquidity levels	Capital adequacy ratio and liquidity ratio remained strong.	<ul style="list-style-type: none"> <li><b>Capital adequacy ratio: 16.14%</b></li> <li><b>Liquidity ratio: 36.03%</b></li> </ul>

1. ROE represents return on average shareholders' funds and is defined in "Financial Highlights".

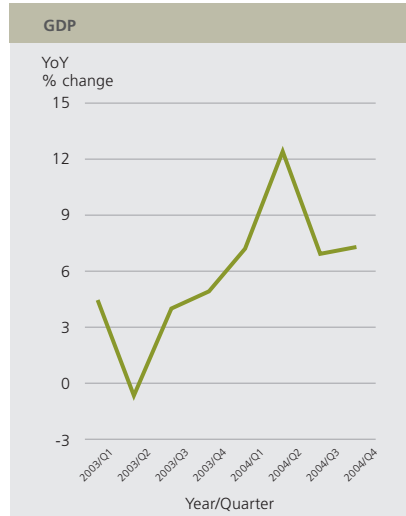
2. ROA represents return on average total assets and is defined in "Financial Highlights".

3. Non-interest income represents other operating income.

4. Percentage of loans that are classified as substandard, doubtful or loss under the HKMA's loan classification system.

### Business Environment

Benefiting from an improving global economy, the implementation of CEPA and the enlargement of the “individual visit scheme”, the Hong Kong economy continued to revive in 2004. With continuous increase in exports, inbound tourism and domestic demand, real GDP grew by 8.1% in 2004. During the year, unemployment rate dropped to 6.4% in October to December 2004 from 7.1% in January to March 2004 while consumer prices registered mild increases since July 2004.

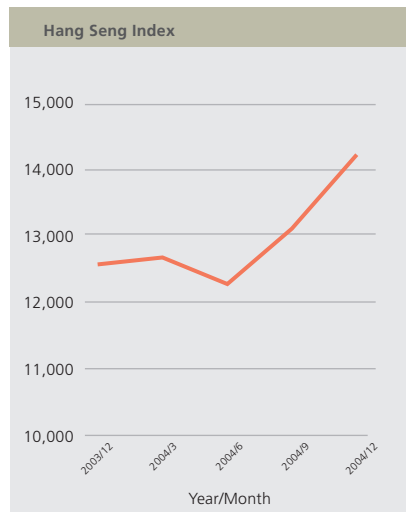


Source: HKSAR Census and Statistics Department

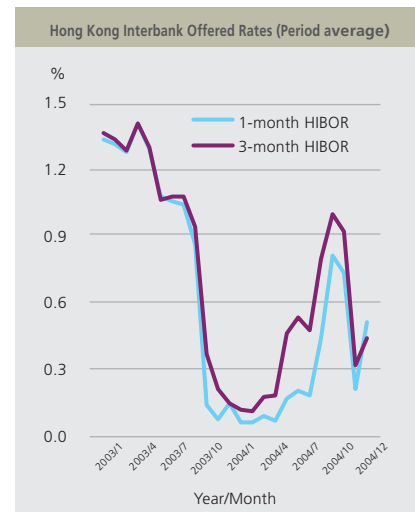


Source: HKSAR Census and Statistics Department

Notwithstanding the economic upturn, the operating environment for the local banking sector continued to be challenging. While consumer confidence, private investment as well as corporate and consumer credit demand regained some growth momentum, the low interest rate environment continued to exert pressure on net interest income.



Source: Bloomberg



Source: Hong Kong Monetary Authority

Although the US Federal Funds Target Rate was raised by an aggregate of 125 basis points to 2.25% by end-2004, HIBOR remained low throughout the year. Average 1-month and 3-month HIBORs were 0.30% and 0.46% respectively, compared to 0.99% and 1.04% in 2003. This had an adverse impact on the larger commercial banks with a more liquid balance sheet.

According to the Stock Exchange statistics, annual stock turnover in 2004 surpassed the record set in 1997 and equity funds raised by IPO also grew significantly from 2003. Investors continued to seek higher-yielding investments and the demand for wealth management products and services increased under the low interest rate environment.

The property market revitalised as prices rebounded, particularly in the luxury residential and commercial property sectors. Both transaction volume and value increased significantly. At the same time, negative equity residential mortgage loans declined sharply. However, intensified market competition further lowered the yield from mortgage loans.

In 2004, the local banking sector benefited from the benign credit environment. Both corporate and consumer credit quality improved significantly. Collateral value and borrowers' business operations picked up, which helped reduce bad debt charges.

The implementation of CEPA and the "individual visit scheme" boosted the economic interaction between the Mainland and Hong Kong. During the year, banks in Hong Kong commenced the personal RMB banking business, including deposits, exchange, remittance and RMB bank cards. These have given rise to more opportunities for growing China-related businesses.

2004 also saw an end to deflation and a return to a slight inflation towards year-end. While this did not cause any major increase in bank operating expenses during the year, it will have an impact in future years.

## Consolidated Financial Review

### Financial Performance

	2004	2003
Operating profit before provisions (HK\$'m)	<b>10,352</b>	11,595
Operating profit after provisions (HK\$'m)	<b>11,980</b>	9,924
Profit before taxation (HK\$'m)	<b>14,252</b>	8,691
Profit attributable to shareholders (HK\$'m)	<b>11,963</b>	7,963
Earnings per share (HK\$)	<b>1.1315</b>	0.7532
Return on average total assets	<b>1.56%</b>	1.08%
Return on average shareholders' funds	<b>18.58%</b>	13.62%

For the year ended 31 December 2004, the Group's profit attributable to shareholders was HK\$11,963 million, up HK\$4,000 million or 50.23% from 2003. Earnings per share were HK\$1.1315, up HK\$0.3783. Return on average total assets and return on average shareholders' funds increased by 0.48 percentage point and 4.96 percentage points to 1.56% and 18.58% respectively.

Operating profit before provisions was HK\$10,352 million, a drop of HK\$1,243 million or 10.72%. The decrease was mainly attributable to a decline in net interest income, which was partially offset by an increase in net fees and commission income and a decrease in operating expenses. Operating profit after provisions rose by HK\$2,056 million, or 20.72%, to HK\$11,980 million, mainly due to provision write-back and recoveries of loans previously written off. After taking into account a property revaluation gain of HK\$1,862 million, profit before taxation reached HK\$14,252 million, up HK\$5,561 million or 63.99%.

### Net Interest Income and Margin

HK\$m, except percentage amounts	2004	2003
Interest income	<b>15,678</b>	17,759
Interest expense	<b>(4,485)</b>	(4,885)
Net interest income	<b>11,193</b>	12,874
Average interest-earning assets	<b>721,402</b>	706,479
Net interest spread	<b>1.46%</b>	1.73%
Net interest margin	<b>1.55%</b>	1.82%

Net interest income fell by HK\$1,681 million, or 13.06%, to HK\$11,193 million from 2003. During the year, average interest-earning assets grew by HK\$14,923 million, or 2.11%, to HK\$721,402 million. Net interest margin fell by 27 basis points to 1.55% due to the contraction of net interest spread.

Low interest rates continued to exert pressure on net interest income for banks with a high proportion of assets deployed in the short-term money market. In 2004, average 1-month HIBOR dropped by 69 basis points to 0.30%. This greatly affected the yield from average interbank placements that fell by 64 basis points from 2003. The yield of average advances to customers also declined by 34 basis points. On the one hand, the repricing of HIBOR-based loans and keen competition affected the yield of average corporate loans. On the other hand, the yield of the residential mortgage portfolio also dropped as market competition intensified during the year. The weighted average residential mortgage yield was 217 basis points below best lending rate, a drop of 26 basis points as compared to 2003. However, the yield from debt securities only dropped marginally by 6 basis points as the Group implemented more active balance sheet management to maximise return. The overall impact was a 34-basis point drop in the yield from average interest-earning assets. Cost of funding, mainly from deposits from customers, fell by 7 basis points as HIBOR stayed low during the year. As a result, both net interest margin and net interest spread contracted by 27 basis points.

**Other Operating Income**

HK\$m, except percentage amounts	2004	2003
Bills commissions	547	556
Loan commissions	490	473
Wealth management income	1,361	1,064
Stockbroking	836	696
Asset management	233	211
Life insurance	194	120
Bonds	98	37
Trust services	75	76
Payment services	349	315
Credit cards	666	560
Others	819	811
Fees and commission income	4,307	3,855
Fees and commission expenses	(1,086)	(858)
Net fees and commission income	3,221	2,997
Dividend income from investments in securities	14	45
Net gain/(loss) from other investments in securities	29	(108)
Net gain from foreign exchange activities	1,056	965
Net gain from other dealing activities	82	42
Net rental income from investment properties	141	161
Others	121	277
Other operating income	4,664	4,379
Non-interest income to total operating income ratio	29.41%	25.38%

Other operating income was HK\$4,664 million, up HK\$285 million or 6.51% from 2003. It accounted for 29.41% of total operating income, an increase of 4.03 percentage points from last year. Net fees and commission income increased by HK\$224 million, or 7.47%, to HK\$3,221 million, as revenue from the Group's wealth management business recorded a strong growth of HK\$297 million.

Income from loan and bills commissions stayed flat, reflecting tighter margins due to keen market competition. The surge in wealth management income by 27.91% to HK\$1,361 million was primarily driven by increases in income of HK\$74 million, or 61.67%, from the distribution of life insurance products, HK\$140 million, or 20.11%, from stockbroking and HK\$61 million, or 164.86% from structured notes and bond sales. These results reflected the success of the Group's strategic focus on growing its wealth management business to take advantage of the increased demand for higher-yielding investments in the low interest rate environment. Income from payment services rose by HK\$34 million, or 10.79%, driven by the growth in remittance transactions. Income from card business also recorded a growth of HK\$106 million, or 18.93%, as cardholder spending and merchant acquiring volumes increased by 31% and 37% respectively. With the introduction of personal RMB banking services at the beginning of 2004, RMB-related businesses contributed HK\$26 million of fee income. The increase in fees and commission income was partially offset by higher fees and commission expenses from credit card and residential mortgage businesses.

Compared to the first half of the year, loan and bills commission income for the second half outperformed the first half as business volume increased. Wealth management income in the second half of the year was lower mainly due to the drop in stockbroking transaction volume, generally in line with a fall in market turnover. Sales of life insurance products and investment funds also shrank as the demand for these products reduced in an interest rate hike environment.

Net gain from other investments in securities amounted to HK\$29 million as compared to a net loss of HK\$108 million in 2003, which was due to losses from the disposal of debt securities.

Net gain from foreign exchange activities increased by HK\$91 million, or 9.43%, as business volume rose.

### Operating Expenses

HK\$'m, except percentage amounts	2004	2003
Staff costs	3,291	3,316
Premises and equipment expenses (excluding depreciation)	725	732
Depreciation on owned fixed assets	585	611
Other operating expenses	904	999
Operating expenses	5,505	5,658
Cost to income ratio	34.72%	32.79%

Operating expenses decreased by HK\$153 million, or 2.70%, to HK\$5,505 million, as a result of disciplined cost control and improvement in operational efficiency. Staff costs fell by HK\$25 million, or 0.75%, to HK\$3,291 million, as headcount decreased. Headcount measured in full time equivalents was 12,976 at end-2004, a decrease of 161 from end-2003. The reduction in other operating expenses of HK\$95 million, or 9.51%, was attributable to the one-off professional fees incurred for a special review in 2003. The slight rise in cost to income ratio of 1.93 percentage points was due to the decline in total operating income.

### Provisions for Bad and Doubtful Debts

HK\$'m	2004	2003
Specific provisions		
– new provisions	(1,520)	(3,834)
– releases	1,851	768
– recoveries	1,356	438
General provisions	1,687	(2,628)
	(59)	957
Net credit/(charge) to profit and loss account	1,628	(1,671)

A net provision write-back of HK\$1,628 million was recorded in 2004 as compared to a net charge of HK\$1,671 million in 2003. New specific provision charge was down by HK\$2,314 million, or 60.35%, to HK\$1,520 million, mainly due to lower bad debt formation as the Group's asset quality continued to improve. This represented a HK\$9,129 million, or 85.73%, reduction in new specific provision charge during the Group's merger and structuring in 2001. The significant improvement was due to continuous enhancement of risk management practices since then. Releases in specific provisions increased by HK\$1,083 million, or 141.02% to HK\$1,851 million, reflecting the increase in collateral value and strong collection brought by improvement in the economy and property market. As a result of the Group's relentless effort, the recovery of loans previously written off rose by HK\$918 million, or 209.59%, to HK\$1,356 million. General provision charge was HK\$59 million due to increase in loan balance.

### Property Revaluation

HK\$m	2004	2003
Increase/(decrease) in property revaluation reserves		
– Premises	2,895	(48)
– Investment properties	629	–
	3,524	(48)
Credited/(charged) to profit and loss account		
– Premises	1,337	(741)
– Investment properties	525	(370)
	1,862	(1,111)
Credited to minority interests		
– Premises	28	–
– Investment properties	1	–
	29	–
	5,415	(1,159)

The Group registered an increase in valuation of properties amounting to HK\$5,415 million in 2004, reflecting the increase in market value in a more robust property market. Premises and investment properties were revalued on the basis of their open market value on 31 October 2004 by Chesterton Petty Limited, an independent firm of chartered surveyors. The revaluation resulted in a credit to the profit and loss account of HK\$1,862 million, which included a revaluation gain on premises and investment properties of HK\$1,337 million and HK\$525 million respectively. The remaining revaluation surplus was mainly recognised in property revaluation reserves.

### Taxation

HK\$m	2004	2003
Hong Kong profits tax	2,113	576
Overseas taxation	17	11
Share of taxation attributable to associates	1	2
Taxation	2,131	589

Taxation for 2004 was HK\$2,131 million, up HK\$1,542 million or 261.80%, when compared to 2003. The increase was partly due to a HK\$732 million write-back of tax provisions in 2003 that was no longer required after the Inland Revenue Department finalised the tax losses of the Group's predecessor merging branches and the tax position of BOCHK, and partly due to higher profit before taxation in 2004. The effective tax rate of the Group in 2004 was approximately 15%, which stayed flat when compared to last year after excluding the effect of tax provision write-back in 2003.

### Financial Position

HK\$m, except percentage amounts	<b>At 31 December 2004</b>	At 31 December 2003
Cash and short-term funds	<b>102,647</b>	134,106
Placements with banks and other financial institutions maturing between one and twelve months	<b>107,581</b>	78,240
Certificates of deposit held	<b>22,338</b>	18,776
Hong Kong SAR Government certificates of indebtedness	<b>34,760</b>	31,460
Investments in securities*	<b>189,388</b>	172,518
Advances and other accounts	<b>309,211</b>	300,094
Fixed assets	<b>21,877</b>	17,582
Other assets **	<b>8,974</b>	9,811
<b>Total assets</b>	<b>796,776</b>	762,587
Hong Kong SAR currency notes in circulation	<b>34,760</b>	31,460
Deposits and balances of banks and other financial institutions	<b>34,440</b>	41,347
Deposits from customers	<b>631,330</b>	600,642
Certificates of deposit issued	<b>3,788</b>	2,432
Other accounts and provisions	<b>22,698</b>	25,289
<b>Total liabilities</b>	<b>727,016</b>	701,170
Minority interests	<b>1,239</b>	1,156
Shareholders' funds	<b>68,521</b>	60,261
<b>Total liabilities and capital resources</b>	<b>796,776</b>	762,587
<b>Loan to deposit ratio</b>	<b>49.61%</b>	51.38%

\* Investments in securities comprise held-to-maturity securities, investment securities and other investments in securities.

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

Total assets were HK\$796,776 million as at 31 December 2004, up HK\$34,189 million or 4.48%, from end-2003.

Cash and short-term funds fell by 23.46%. At the same time, placements with banks and other financial institutions maturing between one and twelve months increased by 37.50%. Investments in securities rose by 9.78% and the duration extended.

Fixed assets increased by HK\$4,295 million, or 24.43%, to HK\$21,877 million, primarily due to the rise in the valuation of premises and investment properties of HK\$5,415 million.



**Advances to Customers**

HK\$m, except percentage amounts	At 31 December		At 31 December	
	2004	%	2003	%
Industrial, commercial and financial	<b>148,034</b>	<b>47.26%</b>	155,839	50.50%
Individuals	<b>124,687</b>	<b>39.81%</b>	118,962	38.55%
Trade finance	<b>13,279</b>	<b>4.24%</b>	12,100	3.92%
Loans for use outside Hong Kong	<b>27,226</b>	<b>8.69%</b>	21,681	7.03%
	<b>313,226</b>	<b>100.00%</b>	308,582	100.00%

The Group's advances to customers marginally increased by HK\$4,644 million, or 1.50%, from end-2003 despite large write-off and collection amounting to HK\$2,856 million and HK\$7,323 million respectively. Loan to deposit ratio was 49.61% as at 31 December 2004, down 1.77 percentage points from end-2003.

The Group's efforts to achieve loan growth was better reflected in the growth in performing loans. As at 31 December 2004, the Group's performing loans rose by HK\$13,237 million, or 4.55%, from end-2003. Moreover, the Group continued to diversify its loan portfolio by growing retail loans and overseas lending, particularly the loan portfolio of Mainland branches. As a result, lending to individuals and loans for use outside Hong Kong accounted for 39.81% and 8.69% respectively of the total advances to customers, representing a rise of 1.26 and 1.66 percentage points respectively from end-2003. As a whole, the Group has achieved an improved and more diversified loan mix covering both corporate and retail loans as well as local and overseas loans.

Regarding loans for use in Hong Kong, lending to individuals showed solid growth of HK\$5,725 million or 4.81%, primarily driven by an increase of HK\$5,612 million, or 6.24%, in residential mortgage loans (excluding those under the government-sponsored home purchasing schemes). Credit card advances also rose by HK\$500 million, or 13.31%, reflecting the success of the Group's strategic initiative in growing the consumer credit business. Lending to industrial, commercial and financial sectors declined by HK\$7,805 million, or 5.01% largely due to write-off and collection. Meanwhile, trade finance grew by 9.74%.

The 25.58% growth in loans for use outside Hong Kong was mainly driven by the increase in lending by the Group's Mainland branches and overseas lending.

**Deposits from Customers**

HK\$m, except percentage amounts	At 31 December		At 31 December	
	2004	%	2003	%
Demand deposits and current accounts	<b>32,470</b>	<b>5.14%</b>	26,974	4.49%
Savings deposits	<b>296,462</b>	<b>46.96%</b>	271,439	45.19%
Time, call and notice deposits	<b>302,398</b>	<b>47.90%</b>	302,229	50.32%
	<b>631,330</b>	<b>100.00%</b>	600,642	100.00%

Total liabilities grew by HK\$25,846 million, or 3.69%, to HK\$727,016 million from end-2003, mainly caused by a rise in deposits from customers.

Deposits from customers increased by HK\$30,688 million, or 5.11%, to HK\$631,330 million from end-2003. During the year, the interbank liquidity remained high in Hong Kong. Despite the low interest rate environment, customers continued to place funds in savings and current accounts for liquidity preference. Savings deposits rose by HK\$25,023 million, or 9.22%, to HK\$296,462 million. For RMB deposits, the Group has continued to be a leading provider of personal RMB banking services since the launch of the services in early 2004.

### Asset Quality

HK\$m, except percentage amounts	At 31 December 2004	At 31 December 2003
Advances to customers	<b>313,226</b>	308,582
General provisions	<b>(5,465)</b>	(5,406)
Specific provisions	<b>(2,320)</b>	(5,507)
General provisions as a percentage of advances to customers	<b>1.74%</b>	1.75%
Specific provisions as a percentage of advances to customers	<b>0.74%</b>	1.78%
Total provisions as a percentage of advances to customers	<b>2.49%</b>	3.54%
Non-performing loans	<b>9,239</b>	17,832
Specific provisions made in respect of non-performing loans	<b>(2,269)</b>	(5,467)
Specific provisions as a percentage of non-performing loans	<b>24.56%</b>	30.66%
Specific provisions and collateral coverage for classified loans	<b>91.66%</b>	90.95%
Total provisions as a percentage of non-performing loans	<b>84.26%</b>	61.20%
Non-performing loans as a percentage of advances to customers	<b>2.95%</b>	5.78%
Classified loan ratio	<b>2.95%</b>	5.82%
Residential mortgage loans* – delinquency and rescheduled loan ratio**	<b>0.61%</b>	1.10%
Card advances – delinquency ratio**#	<b>0.38%</b>	0.75%
	<b>2004</b>	2003
Card advances – charge-off ratio#	<b>3.96%</b>	8.86%

\* 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 total amount of overdue loans (more than three months) to total outstanding loans.

# Computed according to the HKMA's definition.

During the year, the Group's asset quality showed remarkable improvement, attaining the lowest level of NPL ratio since 2001. Both the NPL ratio and the classified loan ratio were at 2.95%, down 2.83 and 2.87 percentage points respectively. NPLs decreased by HK\$8,593 million, or 48.19% to HK\$9,239 million as at 31 December 2004.

The substantial improvement in asset quality was attributable to the Group's effective risk management and collection efforts. At the same time, the recovery of the economy and increased collateral values were also key factors. During the year, net new formation of classified loans was kept at a very low level, amounting to approximately HK\$1.4 billion, or less than 0.5% of total loan outstanding, compared to HK\$6.3 billion in 2003. Moreover, as at 31 December 2004, classified loan ratio of loans originated after the merger and restructuring of the Group in 2001 was slightly less than 1%, indicating the higher quality of new loans granted since then.

Collateral coverage for classified loans increased to 67.17% from 60.54% at end-2003 due to the increase in collateral value and write-off. Specific provisions and collateral coverage for classified loans was 91.66%, up 0.71 percentage point, compared to 90.95% in 2003. Total provisions as a percentage of NPLs rose significantly by 23.06 percentage points from end-2003 to 84.26% as at 31 December 2004.

The quality of the Group's residential mortgage loans continued to improve. The combined delinquency and rescheduled loan ratio decreased from 1.10% to 0.61%, lower than the market average of 0.85%. The quality of card advances also improved, with charge-off ratio and delinquency ratio falling by 4.90 percentage points and 0.37 percentage point to 3.96% and 0.38% respectively, which were better than the market average.

All these achievements reflect the Group's success in enhancing risk management standards to align with international best practices and in building a more rigorous risk management culture in its daily business operation.

### Capital and Liquidity Ratios

HK\$m, except percentage amounts	At 31 December 2004	At 31 December 2003
Tier 1 capital	<b>60,905</b>	56,755
Tier 2 capital	<b>5,049</b>	4,997
Unconsolidated investments and other deductions	<b>(1,257)</b>	(1,429)
Total capital base after deductions	<b>64,697</b>	60,323
Risk-weighted assets		
On-balance sheet	<b>369,875</b>	362,531
Off-balance sheet	<b>34,045</b>	37,249
Deductions	<b>(3,091)</b>	(622)
Total risk-weighted assets	<b>400,829</b>	399,158
Total risk-weighted assets adjusted for market risk	<b>400,977</b>	396,682
Capital adequacy ratios		
Before adjusting for market risk		
Tier 1	<b>15.19%</b>	14.22%
Total	<b>16.14%</b>	15.11%
After adjusting for market risk		
Tier 1*	<b>15.19%</b>	14.31%
Total*	<b>16.13%</b>	15.21%
	<b>2004</b>	2003
Average liquidity ratio	<b>36.03%</b>	37.76%

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

The consolidated capital adequacy ratio increased by 1.03 percentage points to 16.14% as at 31 December 2004, compared to 15.11% at end-2003, mainly due to a growth of the Group's total capital base after deductions.

The capital base after deductions grew by HK\$4,374 million as retained earnings increased. Total risk-weighted assets rose by HK\$1,671 million, primarily because of an increase in on-balance sheet risk-weighted assets by HK\$7,344 million, a decline of HK\$3,204 million in off-balance sheet risk-weighted assets and an increase in deductions by HK\$2,469 million. The growth in on-balance sheet risk-weighted assets was due to an increase in interbank placements and debt securities investments while off-balance sheet risk-weighted assets declined as a result of a decrease in other commitments with an original maturity of one year and over. The increase in deductions of risk-weighted assets was due to an increase in the valuation of premises and investment properties.

BOCHK's average liquidity ratio was 36.03%, down 1.73 percentage points from end-2003, mainly due to a decrease in average 1-month net interbank placements.

## Business Review

### Commercial banking

The Commercial Banking segment consists of the Retail Banking and Corporate Banking businesses.

HK\$'m	2004	2003
Net interest income	7,880	9,392
Other operating income	3,288	3,116
Operating income	11,168	12,508
Operating expenses	(4,317)	(4,373)
Operating profit before provisions	6,851	8,135
Write-back of/(charge for) bad and doubtful debts	1,628	(1,671)
Operating profit after provisions	8,479	6,464
Segment assets	317,064	310,008
Segment liabilities	651,539	621,211

Note: For additional segmental information, see Note 40 to the accounts.

### Segment financial highlights

- Net interest income decreased by HK\$1,512 million, or 16.10%, to HK\$7,880 million. The decrease was mainly due to a narrowed deposit spread, which was partially offset by an increase in income from the Retail Banking loan portfolio, mainly comprising residential mortgage loans as the HKD Prime and HIBOR spread widened and the balance increased. Net interest income from Corporate Banking declined marginally as compared to 2003.
- Other operating income grew by HK\$172 million, or 5.52%, to HK\$3,288 million, driven by strong revenue growth from the Group's wealth management business.
- Costs remained under prudent control.
- Owing to improved asset quality and strong recoveries, there was a significant provision write-back from the Corporate Banking loan portfolio.

- Overall, the provision write-back offset the decline in net interest income, resulting in a net growth of HK\$2,015 million, or 31.17%, in the Commercial Banking segment's operating profit after provisions.

### **Retail banking**

**Solid growth in all major business areas.** To diversify the Group's income streams, wealth management has been a top priority insofar as Retail Banking strategies are concerned. In 2004, the Group aimed at further solidifying its wealth management platform while developing more professional and tailor-made products and services to cater for different customer segments. It also strove to maintain its leading position in the deposit taking and mortgage lending businesses. Strengthening consumer credit and card advances was another key initiative for raising the return of its retail loan portfolio. Moreover, riding on the business opportunities arising from the economic integration between the Mainland and Hong Kong, the Group continued to grow its RMB-related business. In 2004, the Group achieved significant growth in major business areas, namely, wealth management, mortgage, cards and personal RMB banking businesses.

*Wealth management:* Wealth management registered strong growth during the year. The Group has been working closely with investment fund houses and strategic business partners to select a series of performing investment funds and other innovative investment products to fulfil customers' needs. Stockbroking transactions, sales of open-ended funds, structured notes and bonds, and distribution of insurance products grew by 31%, 68%, 27% and 66% respectively. The Group became the Arrangers and Joint Global Coordinators for the HKSAR Government's HK\$20-billion global bond offering in July.

In late 2004, with an enhanced wealth management platform, it launched the Wealth Management Prime services in its 81 wealth management centres and branches. Designated Personal Financial Services Managers provide customers with comprehensive and personalised financial planning services. Furthermore, with the introduction of a sophisticated financial planning tool, Wealth MaxiWiser, the Group further strengthened its professional investment portfolio analysis and recommendations for customers. During the year, the total number of wealth management customers tripled with approximately HK\$130 billion asset under management. The enlarged clientele would provide new impetus to the Group's wealth management business.

*Mortgage:* Despite intense competition, the Group's mortgage business continued to grow and outperform the market. The Group's mortgage balance was up 6.24% from end-2003. To satisfy customers' diverse finance needs under the prevailing low interest rate environment, new products, including the fixed interest rate mortgage scheme and the HIBOR based mortgage scheme, were introduced in 2004. Both schemes were well received by customers. The asset quality of mortgage loans continued to improve as a result of the rise in property price and the Group's effective risk management. The combined delinquency and rescheduled loan ratio fell to 0.61%, lower than the market average. The negative equity ratio dropped to 3.93% at end-2004, compared to the market average of 6.30%.

*Personal loans:* Sustained economic growth and increasing consumer credit demand contributed to the growth of the Group's personal loans, which increased by approximately 6%. During the year, the Group expanded its range of personal loan products and launched iSmart personal loans and iSmart tax loans that allow customers to enjoy a higher degree of financial flexibility.

*Credit cards:* Riding on the growth momentum of 2003, the Group's card business showed outstanding performance in 2004 with 11% increase in net fees and commission income. During the year, a wide range of new services and products were offered to customers. For example, the newly launched Warner Mini Card and 2004 BOC Euro Commemorative MasterCard were both well received by customers. The Group was also the first bank in Asia to launch Euro-denominated credit cards. At the same time, it expanded its business to Macau with the issuance of Platinum MasterCard.

Compared to 2003, cardholder spending and the number of cards issued grew by 31% and 34% respectively. Merchant acquiring volume rose by 37%. Meanwhile, card receivable balance increased by 13.31%, higher than the market growth rate. The reviving economy also helped improve the charge-off ratio and delinquency ratio to 3.96% and 0.38% respectively, well below the market average.

The continual success of the Group's card business further solidified its position in the industry. In 2004, it received several awards from Visa International and MasterCard International.

The Group's China-related card business achieved important milestones in 2004. It pioneered the launch of the China UnionPay Card acquiring business in Hong Kong in January. With over 6,400 new terminals in over 4,000 merchant sales points at end-2004, the Group has been providing reliable and convenient payment service to the Mainland UnionPay cardholders in Hong Kong. In September, China UnionPay Card acquiring business was also extended to Macau.



*Personal RMB banking business:* The Group has maintained its market leadership in offering personal RMB banking services since launching the business in February. It was the first bank to offer a comprehensive range of RMB products and services, including deposits, exchange, remittances and cards. It also provides an extensive service network, comprising branches, ATMs, Internet banking and telephone banking. RMB withdrawal services are made available via its 232 ATMs throughout Hong Kong. It pioneered the issuing of RMB credit cards in April and led the local RMB card business by having issued over 50,000 RMB cards at end-2004.

*Channels:* In order to optimise its branch network and align with its wealth management strategies, the Group continued to reengineer its distribution network. During the year, 7 branches were closed and 1 branch was opened in Hong Kong. As at end-2004, the total number of branches in Hong Kong was 283 and the number of ATMs was 447, as compared to 289 and 449 respectively at end-2003.

Good progress was made in strengthening the Group's e-business channels. During the year, new functions were incorporated in the Group's Internet banking services, including new on-line wealth management services, transfers, RMB banking services and credit card payment services. By end-2004, the number of IT's Banking customers grew by 15% and the number of transactions doubled that in 2003.

### **Corporate banking and financial institutions**

**Growing with a new business model.** As one of the largest corporate lenders in Hong Kong, the Group is committed to becoming a close partner to customers by offering a comprehensive range of financial services to meet their specific needs. Capitalising on the strengths and capabilities that it possess, it aims at expanding its market share and building its high-return business.



*New business model:* In 2004, the Group refined its customer and product management framework. The new business model is more customer-centric, emphasising the development of business strategies appropriate for different customer segments so that the Group can become its customers' preferred banker. Under this model, corporate relationship managers have been re-organised in accordance with their industrial specialty to work closely with a team of product managers. The former specialises in customer relationship management whereas the latter's expertise is in product development. The two teams collaborate with each other to ensure that customers' needs are satisfied with the best products. This approach not only enables the Group to provide customers with quality products and services in a timely and cost-effective way, but also prepares it for new business opportunities.

*Business development and asset quality improvement:* The Group has maintained its competitive advantage in Corporate Banking business. In 2004, it was ranked by Basis Point, a leading source of Asian debt market news and analysis, as the second largest local syndicated lending arranger. Focusing on strengthening its trade finance services, the Group achieved high ratings in the service quality of import and export factoring at a competition organised by Factors Chain International, a global network of leading factoring companies. Despite intense market competition, the Group's trade bills transaction volume increased by 13%. Trade finance related loans also grew by 9.74%.

During the year, effective collection and write-off were implemented. By the end of 2004, the Group's overall corporate loan quality improved substantially as evidenced by the record low classified loan ratio and bad debt formation level since the Group's restructuring in 2001.

*Channels:* The Group undertook various initiatives to improve its product quality and operational efficiency. In February 2004, it launched the Financial Institutions Online, which allows correspondent banks to manage their accounts via Internet. In May 2004, the CBS Online was rolled out, enabling corporate clients to manage their accounts via the Internet. By the end of 2004, the number of CBS customers increased by 42%. These initiatives also facilitate the development of the Group's cash management business.

*Clearing and settlement services:* Appointed by the PBOC as the clearing Bank for RMB business in Hong Kong, the Group launched RMB clearing services in February 2004, serving 38 participating banks. It was also appointed the agent bank for the HKD and USD RTGS Link between the Guangdong Province and Hong Kong in March. In July, the Group was nominated by the PBOC as the agent bank for the USD Joint Cheque Clearing Service between Shenzhen and Hong Kong.

### **China-related business**

**Robust growth on a solid foundation.** China-related business is one of the Group's core growth areas. The Group's China business model leverages its retail and corporate franchise in Hong Kong, branch network in the Mainland, and close relationship with BOC to provide cross border financial services to customers. The Group's Mainland branch network now acts as an extended arm of its Retail Banking and Corporate Banking business units. New organisational structure, market positioning, customer segmentation and product development strategy have been formulated to drive this new model. The Group has also been taking a new approach in cooperating with BOC in business development by providing complementary financial services to BOC's customers in both Hong Kong and the Mainland.

In 2004, the Group's China-related business continued to deliver good results. The combined operating profit before provisions of the Mainland branches increased by 22% to HK\$147 million. Total advances to customers rose significantly by 53% to HK\$9,345 million while customer deposits grew by 17% to HK\$2,285 million. Asset quality improved considerably with the classified loan ratio falling to 3.26% at end-2004 from 10.35% at end-2003.

The Group has made very good progress in expanding the business scope of its Mainland branches and sub-branches. Further to obtaining the approval to operate RMB business to foreign enterprises, BOCHK's Shanghai and Shenzhen branches (including sub-branches) were allowed to offer RMB business service to Chinese enterprises. In addition, Nanyang's Dalian and Guangzhou branches also obtained the approval for providing RMB business to foreign and Chinese enterprises during the year. Six branches and sub-branches were allowed to commence financial derivatives business. Moreover, benefiting from the implementation of CEPA, BOCHK's Shantou and Shenzhen branches (including sub-branches) were admitted to commence insurance agency business while two other branches have already submitted their documents for insurance agency business.

The Group also undertook to enhance its services through the development of the electronic channel. In January, iT's Online Banking and Telephone Banking were launched successfully, enabling customers to check their account status, review payment records and request for various financial information. Four Mainland branches were also allowed to join the China National Advanced Payment System, which provides real-time, safe and cost-efficient means of fund transfer to the Group's Mainland customers.



### Treasury

The Group's treasury operation covers foreign exchange, gold bullion, derivatives, money markets, and capital markets. The following table summarises the performance of the treasury operation.

HK\$m	2004	2003
Net interest income	2,928	2,982
Other operating income	1,121	918
Operating income	4,049	3,900
Operating expenses	(159)	(162)
Operating profit before provisions	3,890	3,738
Charge for bad and doubtful debts	–	–
Operating profit after provisions	3,890	3,738
Segment assets	456,948	432,947
Segment liabilities	72,453	77,671

Note: For additional segmental information, see Note 40 to the accounts.

#### Segment financial highlights

- Net interest income decreased marginally by HK\$54 million, or 1.81%, to HK\$2,928 million.
- Other operating income increased by HK\$203 million, or 22.11%, to HK\$1,121 million, mainly due to the gain from foreign exchange activities against the losses from the disposal of debt securities in 2003.
- Segment operating profit after provisions increased by HK\$152 million, or 4.07%, to HK\$3,890 million.

**Growth in customer-driven business and active surplus fund management.** The US interest rate hike and the low HIBOR resulted in a very challenging environment for treasury management in 2004. However, the Group strove to stabilise its net interest income through active asset and liability management. During the year, taking advantage of its flexible balance sheet, the Group lengthened the duration of its debt securities portfolio and increased investments in structured bonds and asset-backed securities for higher interest yield.

At the same time, strong emphasis was placed on developing new products and sales channels to improve the Group's non-interest income stream. Through enhanced collaboration with the Retail Banking and Corporate Banking businesses, customer-driven business grew while transaction volumes of foreign exchange, bullion and option-linked deposits increased significantly from 2003. In the fourth quarter, the Group launched the retail currency option trading services.

The Group also managed to grow the number of treasury customers by 14% and increased the transaction volumes of structured products significantly.

### **Technology and operations**

In 2004, the Group made good progress in information technology development. The Group met its targets in 2004 by successfully completing its core banking system enhancement, and various system changes for business development, process re-engineering and compliance-related requirements.

For the core banking system enhancement, the Group completed and launched its new savings account system with increased functionality. In addition, the development of the new banking application system for its Mainland branches, new securities trading system and new trade services system was completed in 2004 and scheduled to be launched in 2005. To develop its wealth management business, the Group completed and launched a new wealth management system offering financial planning and portfolio management services to customers.

To support business development, the Group also achieved the followings:

- Completed CBS Online that offers an Internet-based channel to corporate customers;
- Upgraded IT's banking system;
- Completed linkage of the RTGS system between Hong Kong and Guangdong;
- Completed RMB Settlement Institute Management System for RMB clearing services; and
- Enhanced system functionality to meet the increasing complexity and diversity of its treasury product development.

To increase operational efficiency, the Credit Workflow Management System was launched, which facilitates fast and efficient credit approval and management process for the Retail Banking business. Its usage will be extended to the Corporate Banking business in 2005. Meanwhile, the second phase of the Information Processing Centralisation Project to transfer data entry work to Shenzhen was implemented.

To meet the new financial reporting standards effective in 2005, the Group carried out a system enhancement process to ensure compliance to the new standards. Further system refinement to meet the requirement of the new financial reporting standards will be completed in the first half of 2005.

### **Credit Ratings**

	<b>Long-term</b>	<b>Short-term</b>
Fitch	A	F1
Moody's	A2	P-1
Standard & Poor's	BBB+	A-2

On 1 November 2004, BOCHK obtained the first credit ratings from Fitch Ratings. Fitch Ratings assigned a long-term foreign currency rating of A and a short-term foreign currency rating of F1 to BOCHK. The outlook on the ratings is stable.

As at 31 December 2004, the long-term and the short-term foreign currency bank deposit ratings assigned by Moody's Investor Service to BOCHK were A2 and P-1 respectively. The long-term and short-term counterparty credit ratings assigned by Standard & Poor's to BOCHK were BBB+ and A-2 respectively.

These rating agencies review the ratings assigned to BOCHK periodically and may confirm or change the ratings from time to time as a result of their reviews.

## **Risk Management**

### ***Overview***

Risk management is fundamental to the business of the Group. It is also an integral part of its day-to-day operation and business development strategy. The principal types of risk inherent in the Group's business are credit risk, market risk, interest rate risk, liquidity risk, operational risk, strategic risk, reputation risk, and legal and compliance risk. The Group's risk management goal is to maximise its long-term risk-adjusted return on capital, to reduce volatility in earnings and to enhance shareholder value, while maintaining risk exposures within acceptable limits.

### ***Risk management governance structure***

BOCHK's risk management policies are designed to identify and analyse credit risk, market risk, interest rate 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. BOCHK continually modifies and enhances its risk management policies and procedures to reflect changes in markets and products.

The Risk Committee ("RC", formerly known as Risk Management Committee), established by the Board of Directors as a standing committee, is responsible for approving risk management policies and procedures and major asset and liability management policies proposed by the Asset and Liability Management Committee ("ALCO").

Each Strategic Business Unit ("SBU") is responsible for the implementation of appropriate policies, procedures and controls in relation to risk management under the general guidance of the Chief Risk Officer ("CRO"), who oversees the operation of the Risk Management Department ("RMD").

The Chief Financial Officer ("CFO") has oversight responsibilities for the soundness of the Group's capitalisation and earnings. In addition, the CFO, with the assistance of the Finance Department, monitors the bank-wide interest rate risk and liquidity risk and reports to the ALCO and the RC on a regular basis.

The Audit Department of BOCHK reports directly to the Board and the Audit Committee and is responsible for the monitoring of proper compliance by the Group on all risk management policies and procedures.

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

### **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's primary goal in credit risk management is to maximise its risk-adjusted returns while maintaining its credit risk exposure within acceptable parameters. In particular, BOCHK has developed and is implementing comprehensive policies and procedures to identify, measure, monitor and control credit risk across the organisation.

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

The RC is a board-level committee with the responsibility for determining and revising BOCHK's credit risk management policies and procedures. BOCHK believes that independence and proper check-and-balance are of crucial importance in effective risk management. To ensure independence and checks and balance, under BOCHK's managerial and organisational structure, the RMD and the Audit Department report directly to the RC and the Audit Committee respectively.

The Chief Executive is responsible for, among other things, implementing the credit risk management strategy and policies approved by the Board. He is also charged with balancing BOCHK's goal of generating a reasonable yield on its assets whilst maintaining risk exposures within pre-defined tolerance levels.



The RMD, being structurally independent of credit initiation units, assists the Chief Executive in managing credit risk in accordance with BOCHK's credit risk management strategy and policies. It also provides independent due diligence on identification, measurement, monitoring and control of credit risk. To avoid any potential conflicts of interests, the credit review functions are independent of the business units. Multi-level credit approval authorities are set, depending mostly on the credit officers' professional experience, skills and responsibilities. All credit approval and review authorities originate from BOCHK's Board of Directors.

The Special Assets Management Department is responsible for the collection of NPLs.

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

Low-risk credit transactions that fulfil 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 applications 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 assess if initial credit decisions have been made in accordance with the established procedures.

BOCHK is committed to building a credit scoring system to facilitate credit approval process for retail exposures. Scorecard is a tool for credit risk assessment, using statistical model to analyse applicants' demographic and credit characteristics to predict future repayment performance. With scorecards, credit decisions are made based on credit scoring results, but scoring does not preclude credit officers from making credit judgment. During the year, the first application scorecard for personal unsecured credit facilities was deployed. Several other scorecards for different types of personal lending products are now in the process of implementation.

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.

For loans reaching the approval authority of Deputy Chief Executives 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. Its assessment results will be an important basis for the CRO to make his credit review decision as well as the Chief Executive and Deputy Chief Executives to make their credit approval decisions. The CRAC itself has no credit approval authority.

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

BOCHK has a dedicated division, the Credit Monitoring Division within the RMD, to conduct thorough and comprehensive post-disbursement examination on each obligor and group of obligors in order to identify and control individual and overall credit risk in the loan portfolio.

The early alert programme for identifying potential problem customers has been further enhanced to detect early signs of deterioration in credit status of obligors and to trigger closer monitoring process to prevent further deterioration.

To ensure that adequate efforts are dedicated to improve loan quality, BOCHK has focused more on the monitoring of significant exposures and set up internal targets to evaluate the performance in the resolution of criticised loans. The RMD regularly reports the loan quality to senior management for high-level oversight.

### **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.

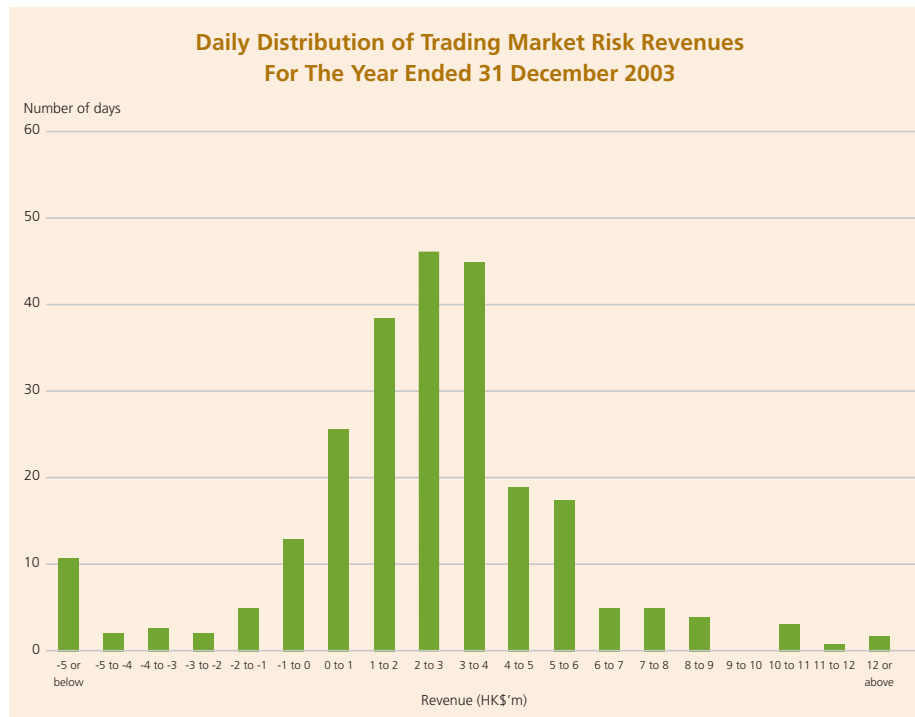
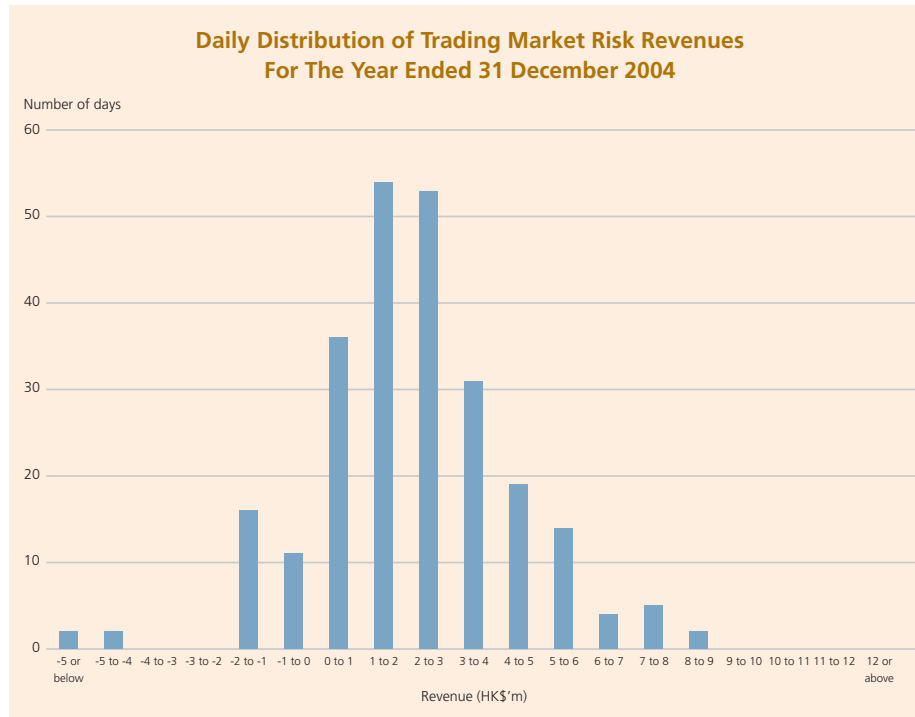
Market risk is managed within the risk limits approved by the RC. The overall risk limits are divided into sub-limits by reference to different risk factors, including interest rate, foreign exchange rate, commodity price and equity price. Considering the different nature of the products involved, limits 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.

At 31 December 2004, the VaR for all trading market risk exposure of BOCHK was HK\$2.9 million (31 December 2003: HK\$0.8 million), the VaR for all trading interest rate risk exposure was HK\$1.9 million (31 December 2003: HK\$0.7 million) and the VaR for all trading foreign exchange risk exposure was HK\$2.3 million (31 December 2003: HK\$0.6 million). For the year ended 31 December 2004, the average VaR was HK\$3.2 million (2003: HK\$5.9 million), with a maximum of HK\$5.6 million and a minimum of HK\$0.9 million for the period.

For the year ended 31 December 2004, the average daily revenue of BOCHK earned from market risk-related trading activities was HK\$2.1 million (2003: HK\$1.9 million). The standard deviation of these daily trading revenues was HK\$2.3 million (2003: HK\$9.0 million). An analysis on the frequency distribution of daily trading revenues illustrated below shows that 31 losses (2003: 36 losses) were recorded out of 249 trading days for the year ended 31 December 2004 and the maximum daily loss was HK\$6.9 million (2003: HK\$119 million). The most frequent result was a daily trading revenue of between HK\$1.0 million to HK\$3.0 million (2003: HK\$2.0 million to HK\$4.0 million). The highest daily revenue was HK\$8.9 million (2003: HK\$36.3 million).



### **Foreign exchange risk management**

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: (1) repricing risk: mismatches in the maturity or repricing periods of assets and liabilities; and (2) 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 ALCO maintains oversight of interest rate risk and the RC sanctions the interest rate risk management policies formulated by the ALCO. The Finance Department, under the supervision of the CFO, 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 result is reported 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 made.



### ***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.

BOCHK manages and measures its liquidity through maintaining strong liquidity ratios (average liquidity ratio for 2004: 36.03%), examining the stability of depositors and the respective concentration risk, monitoring the loan to the 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 and reports BOCHK's on-and off-balance sheet assets and liabilities with regard to the liquidity risk to ALCO.

### ***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 and in preparation for the implementation of Basel II.

BOCHK manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risks, and reviews the risks inherent in business processes, activities and products through internal consultation. BOCHK monitors operational risk losses and reports to the RC and senior management. As part of our effective internal control environment, BOCHK maintains adequate documentation of control procedures for its business processes. 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 the 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 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.

***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 the BOCHK because of poor strategic decisions, improper implementation of decisional strategies and lack of response to the market. BOCHK's Strategic Risk Management Policy defines the responsibilities of the Board and of the Management to ensure that the strategic risks of BOCHK can be effectively taken care of, and desired strategies can be successfully carried out.

***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 rumours 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 Reputation Risk Management Policy. This policy requires established standards to prevent and manage reputation risk proactively at an early stage, monitor external reputation risk incidents and learn from published failures of risk incidents within the financial industry. In order to eliminate or alleviate the negative impact on the 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. The Group has an Investor Relations Committee which is responsible for the monitoring and reacting to such contingencies, and to ensure compliance to the Reputation Risk Management Policy.

***Legal and compliance risk management***

Legal risk is the risk arising from the potential that unenforceable contracts, lawsuits or adverse judgments may disrupt or otherwise negatively affect the operations or financial condition of BOCHK. The Legal and Compliance Department ("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 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, the LCD ensures BOCHK conducts its business in compliance with the requirements of relevant laws and regulations.

## Regulatory Development

### *The New Basel Capital Accord*

In June 2004, the Basel Committee released the New Basel Capital Accord (also referred to as Basel II). Basel II will be implemented globally by end-2006. All internationally active banks in the major financial markets around the world will follow Basel II. The HKMA has announced that local banks will follow the same timetable as the Basel Committee and Hong Kong is among the first to announce its implementation proposals.

Firstly, Basel II helps promote the safety and stability of the banking sector. In assessing the capital requirements for credit risk, a more risk-sensitive approach will be adopted. Banks will be required to hold more capital against high-risk lending. Furthermore, banks will, for the first time, be required to hold capital against operational risk. In addition to credit risk, market risk and operational risk, banks will be required to assess the full range of other type of risks they run and determine how much capital to hold against them. Secondly, Basel II will help promote the adoption of advanced risk management practices. Thirdly, Basel II requires greater public disclosure about a bank's business.

The Group has formulated an implementation plan for Basel II according to the requirements of the Basel Committee and the HKMA. It is developing the required internal risk management system and conducting researches on the whole capital adequacy assessment process. The internal ratings-based approach will also be gradually adopted in the Group's business decisions. In 2005, the Group will closely follow the latest requirements relating to the Basel II set by the HKMA and carry out its implementation plan progressively.





# MAXIMISE Shareholder **Value**

