關於中國銀行（香港）有限公司
公司治理、授信審批程序、
風險管理及內部監控機制的

專責委員會調查報告

Report of the Special Committee

on the Corporate Governance, Credit Approval Process,
Risk Management and Internal Control Mechanisms of
Bank of China (Hong Kong) Limited

二〇〇三年九月
September 2003

中銀香港(控股)有限公司
BOC HONG KONG (HOLDINGS) LIMITED

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Summary of Findings and Recommendations

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

(i) The Current State of the New Nongkai Loan ("the loan")

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

(ii) Errors of Judgment

- The loan was granted according to the procedures and delegated authorities then applicable. Though large, it was not a loan which required Board approval, and therefore would not have come to the Board's attention until circumstances so required e.g. were it to become non-performing;
- As far as we could determine, the procedures were followed, but in our opinion the judgments surrounding the making of the loan were faulty:
    - — Although the risks were identified at the start, they were not adequately addressed in the following respects:
        - ➢ The Bank never obtained sufficient information on Mr. Chau to be able to know his net worth and assess its accessibility;
        - ➢ In order to be repaid, the Bank relied on payments to be made against asset injections to be arranged by Mr. Chau into Shanghai Land, which depended on his good faith and honesty, and on the ability of Mr. Chau and Shanghai Land to comply with the Listing Rules;
        - ➢ The Bank accommodated Mr. Chau's request not to take mortgage rights over properties available for injection into Shanghai Land, based on his representations that the injection of properties so mortgaged might be deemed as "connected transactions". The Bank was thereby put into the position of having to rely on Shanghai Land shares as collateral, coupled with complex and resource intensive loan administration arrangements to protect the value of these shares, by ensuring that there was no dissipation of Shanghai Land's assets or accumulation of liabilities. This further increased reliance on Mr. Chau's good faith and honesty, since no foolproof protection system could be devised;

Summary of Findings and Recommendations *(continued)*

(ii) Errors of Judgment *(continued)*

➢ The bank officials involved in processing the loan showed lack of sensitivity to issues involved in compliance with the Listing Rules. Although the onus was on Mr. Chau through his professional intermediaries to do so, and bank officials did make it an express condition in the loan documentation that Mr. Chau should comply, there was always a risk that there would be public speculation that the Bank may have facilitated the evasion of the Listing Rules, whether or not there was evasion. Because of client confidentiality, the Bank would find it difficult to defend itself in public.

- The Bank was thereby exposed to both credit and reputational risks disproportionate to the rewards deriving from the loan;

- The loan having been made, its subsequent management has been satisfactory, although costly. It has been intensively monitored by management, and as the loan was performing until Mr. Chau's disappearance and the appointment of Receivers to Shanghai Land, there was no cause for the Board to become involved until that stage.

(iii) Who was Responsible

- On the evidence available to the Special Committee, it found no cause to believe that the officials involved in the loan were motivated by anything other than what they saw as the Bank's best interests. It notes that Mr. Chau made an effort to deliver according to the terms of the loan, and did repay a substantial portion of it. Indeed, if the Extraordinary General Meeting of Shanghai Land, called for 3 June 2003 but then postponed, had approved the proposed further asset injection, only a very small amount of the loan would remain outstanding. Current recovery action indicates a possibility that the Bank may make substantial recovery perhaps with little or no loss to the Bank;

- Notwithstanding this, prudent banking practice requires the exercise of good judgment at the beginning, Mr. Chau has disappeared, and the Bank's reputation has been damaged by the adverse publicity surrounding the loan. Having considered the Moores Rowland Report and conducted its own independent inquiries, the Special Committee makes the following criticisms of the two most senior bank officials involved, in descending order of responsibility:

  — **Mr. Liu Jinbao (former Chief Executive)** failed to intervene in the transaction although he knew there were serious reservations, which had not been satisfied. He should have appreciated that Mr. Or's position as de facto Chairman of the Credit Committee would impede its effectiveness when dealing with a loan proposal which Mr. Or advocated, such as the New Nongkai loan;

  — **Mr. Or Man Ah (Deputy Chief Executive for Corporate Banking)** advocated the loan without having sufficient regard to the risks inherent in the transaction and the concerns of the Risk Management Department.

(iv) Actions Already Taken or to be Immediately Taken

- The Credit Committee approval procedure is being replaced by a new procedure, centered on a new Credit Assessment Committee, addressing the imbalance between business generation and risk management and the inherent conflict of interest in the old system;

- The Special Committee recommends that the Board accepts Mr. Or's application for retirement bearing in mind his service record, which but for the lapse of judgment in this instance, has been a distinguished one. His ready acceptance of responsibility shows commendable sense of personal accountability that is entirely consistent with the high regard he is held by his colleagues;

- The Special Committee recommends that the Board address a note of its findings to BOC for Mr. Liu's role in the loan.

Summary of Findings and Recommendations *(continued)*

(v) Building Stronger Foundations

- Based on its review of the KPMG and Moores Rowland findings and its own, independent observations, the Special Committee is satisfied with the continuing integrity of the credit approval, risk management and internal control processes of the Bank. Following the merger from 12 predecessor banks, the Bank has been pursuing a steady program of implementation of the risk management and internal controls processes described in the Prospectus at its IPO and in its 2002 Annual Report. The comprehensive review undertaken in the last three months of the Bank's credit approval, risk management and internal controls processes in the corporate banking business of the Bank shows that the Bank is on track with this program, but the Review has also given the Bank an opportunity to take stock of progress and to consider enhancements to these processes. This review has also afforded the Bank an opportunity to take stock of its corporate governance against increasingly high expectations globally and consider improvements to meet these expectations;

- KPMG have identified a number of detailed deviations of Bank credit and risk management practice from the Bank's own policies and HKMA guidelines. Most of the variations relate to the Bank's own policies, and the Committee notes that the HKMA guidelines are expressed at a high level. The Special Committee is satisfied that the deviations from both internal policies and HKMA guidelines are not serious but should nonetheless be rectified as soon as possible, against a timetable agreed with HKMA, monitored by Internal Audit, reporting to the Audit Committee;

- Further detailed enhancements to risk management, credit approval and internal control processes have been identified by KPMG as desirable even though HKMA guidelines are met. Management should take these forward, subject to Board oversight;

- KPMG have similarly suggested detailed enhancements to the high level controls in place even though HKMA guidelines are met. The Special Committee likewise believes that the Chief Executive should take those forward by formulating detailed proposals to the Board in the manner set out in the section of this Report dealing with Corporate Governance;

- In this Report, the Special Committee wishes to highlight to the Board the areas of enhancements in processes and high level controls that will most benefit the Bank.

(vi) Enhancing Management Structure

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

- Recognition of the importance of risk management, which is underlined by the lessons learnt from the New Nongkai loan, should be enhanced. This could be done by elevating the position of Chief Risk Officer in seniority to rank alongside the heads of business generation, as Director of Risk. He will report directly to the Chief Executive and to the Board. His duty would be to ensure the Bank continues to maintain best international practice in credit, market, operational, legal and compliance risk control. This will require the position to be filled by a world class candidate, through competition open to inside and outside applicants;

- A new position of Chief Operating Officer should be established. His remit would be to help the Chief Executive co-ordinate and implement the many change programs now underway in the Bank, together with the enhancements proposed as part of this Review, and thereby deliver an operational capability for the Bank which meets best international practice. He will report directly to the Chief Executive and to the Board, and should rank alongside the existing Deputy Chief Executives. This will require the position to be filled by a world class candidate, through competition open to inside and outside applicants;

Summary of Findings and Recommendations *(continued)*

(vi) Enhancing Management Structure *(continued)*

- In order that the Bank may achieve its ambition to become a first class international bank, the Chief Executive will need the full support of the Board to allow him the resources required to accomplish this. Not only will the Chief Executive need to recruit the best candidates for the two senior positions identified here by the Special Committee, he will have to design in conjunction with the Board, bank wide human resource and remuneration policies, which will be conducive to identifying and retaining the best candidates for all key positions in the Bank;

- The Special Committee notes that the right human resource and remuneration policies need not increase overall cost but should aim at paying the right persons the right compensation and staffing the Bank at a level which is supported by the business generated.

(vii) Enhancing Corporate Governance

- Though they have reported that the high level controls within the Bank meet HKMA guidelines, KPMG have made a number of suggestions and recommendations about the Board committee structure, nominations, agenda management, self-assessment, and other matters of corporate governance. The Special Committee notes that all of these recommendations are broadly in line with thinking already underway within the Board and therefore deserve to be implemented, but some command more priority than others;

- The most immediate priority relates to independent non-executive directors, following Mr. Chia's retirement. His replacement should have experience which would ideally include one or more of the fields of corporate governance, change management, project management, and banking related risk management. In order to gain the desired spread within the experience spectrum just mentioned, possibly more independent non executive directors should be appointed;

- KPMG have suggested the setting up of an Executive Committee and the appointment of additional executive directors. This recommendation deserves careful study. The Board should task the Chief Executive to conduct a study of the need and feasibility of an executive committee and if thought fit, to include detailed proposals in a report to the Board, within 6 months, bearing in mind the need for the Chief Executive to first attend to the enhancement of the management structure;

- The Special Committee recommends that Compliance (which is presently overseen by a Sub-Committee of the Audit Committee and comprised of Bank executives and a co-opted member from BOC) should be recognised as part of the risk management function of the Bank, and so recommends that the Board's Risk Management Committee should also become responsible for Compliance and the Risk Management Committee should immediately ask the Chief Executive to review whether he is satisfied that there is sufficient capability in the Legal & Compliance Department to provide compliance support to securities markets issues encountered in the Bank's lending transactions;

- The Board should task the Audit Committee to commission a more detailed review of the internal audit process against international banking best practice, to ensure that the Internal Audit function delivers the highest possible added value in addition to complying with best international practice;

- The Chief Executive should be tasked to assess KPMG's other detailed suggestions for their value in promoting operational efficiency and effectiveness of the Board, reporting to the Board within 3 months.

Summary of Findings and Recommendations *(continued)*

(viii) Conclusion — Reaching for Higher Standards

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

- The priority is to ensure that the Bank has an enhanced top management team to support the Chief Executive and in this respect, it is important to select, as soon as possible, the new Chief Operating Officer and Director of Risk. These should be persons with sufficient experience to bring international best practice into the Bank, and with the right qualities to bring forward the ambitious program of change that the Bank has already committed to undertake in its merger plans. The next priority is to make sure that the Bank has the human resource and compensation policies which are conducive to ensuring that the best candidates are placed and retained in all key positions in the Bank. Only then, can the Bank truly aspire to be a bank which is capable of operating under best international practice;

- Board leadership will play a critical role in the effort to achieve best international practice. The Chief Executive should be given the fullest support by the Board to motivate the staff to implement the change program already under way, which this Review seeks to enhance. It is only through the joint effort of the Board, the management and the staff that the Bank may emerge as a stronger institution, ready to reach for higher standards.

I. Introduction

1. The Special Committee was appointed by the Board on 17 June 2003 and its full terms of reference are contained in Appendix 1. A glossary of abbreviations and definitions contained in this report is contained in Appendix 2. In brief, as stated in the Bank's announcement of 17 June 2003, they are "*to review the credit approval, risk management and internal control processes of BOCHK, as well as the effectiveness of the high level controls exercised over these matters by the Board*", including the circumstances surrounding the approval of the New Nongkai loan, and report to the Board through the Audit Committee. With the Board's approval, the Special Committee appointed Mr. Richard Farrant as the Committee's Special Adviser.

2. Principal inputs to the review are the Moores Rowland and KPMG reports, the first specifically covering the Chau related loans; the second covering a wide range of other corporate lending and risk and general management issues. Moores Rowland and KPMG were appointed to assist the Special Committee and as special auditors for a report to be made to the HKMA under Section 59 of the Banking Ordinance. The staff who have been directly involved in the New Nongkai loan transaction were independently interviewed by the members of the Special Committee, as were staff involved in the credit and risk management process generally. In addition, Goldman Sachs and UBS, our sponsors in the IPO, have given views as to market perceptions arising from the New Nongkai loan and how the reforms under consideration would or would not address concerns of the market, for which we are grateful. Summaries of the Moores Rowland and KPMG reports are in Appendices 3 and 4. A list of the staff and external parties interviewed is in Appendix 5. The Special Committee has received full co-operation from all concerned. The reports of the two special auditors have been submitted to the HKMA as required under Section 59 of the Banking Ordinance.

3. In the past 3 months, the credit and risk management processes of the Bank have been closely studied by the Special Committee, assisted by the two special auditors (Moores Rowland and KPMG). Few organisations in the world have been put under such close and detailed scrutiny. With 13,000 staff, the Bank is still adjusting to the merger from its 12 predecessor banks. As the Bank goes about dealing with existing and generating new business, it has at the same time embarked on a series of reforms in its business processes as part of its ambitions to be become a first class international bank. The review undertaken by the Special Committee provides the Bank with an opportunity to take stock of what has been achieved to date, re-assess priorities and enhance its plans. The Special Committee is satisfied with the continuing integrity of the Bank's credit approval process, and its risk management and internal controls systems. Whilst the New Nongkai loan has created adverse publicity for the Bank, it has on the other hand provided useful lessons for the future. The recommendations made in this Report are intended to help the Bank bring forward its plans and achieve its stated objective of becoming a first class international bank. They have the full support of the Chief Executive who now faces the task of motivating his management team and the staff to take ownership for them. The Chief Executive must have the fullest support from the Board so that he may achieve this.

II. The New Nongkai Loan

The Current State of the Loan

4. The original amount of the bridging loan was HK$1.77 billion (which was the final amount drawn from a facility of HK$2.107 billion), of which HK$1.03 billion has been repaid, leaving HK$740 million outstanding. As collateral for the outstanding loan, the Bank has a first legal charge over 75% of the shares of Shanghai Land.

5. Shanghai Land announced on 9 June 2003 that Receivers had been appointed by the Court, on the grounds, inter alia, that there was no governing body of executive directors comprising the Board. This followed the disappearance of Mr. Chau, who was believed to be detained in China. The Receivers maintain in their name HK$1.2 billion in a deposit with the Bank. The Bank understands that, on the basis of the present information available to the Receivers, the company has few liabilities which could be applied against this deposit;

6. The Special Committee is satisfied that active steps are being taken for recovery of the outstanding amount of the loan. The loan was assessed by Moores Rowland as part of their Section 59 Review. They recommended, as at 31 May 2003, a loan classification of "special mention" and, consistent with that, made no recommendation for a specific provision. However, the loan is currently classified by the Bank as "substandard", and provision of HK$126 million made as a matter of prudence. PwC has concurred with the level of specific provision made by the Bank in the audited accounts for the six months ended 30 June 2003.

Errors of Judgment

7. In making every loan a bank puts itself under the risk of non repayment. The decision to make a loan therefore involves a judgment which appropriately balances risk against rewards. In the case of the New Nongkai loan, the judgments made did not comprise the appropriate balance, exposing the Bank to credit as well as reputational risk disproportionate to the rewards deriving from the loan:

   (i) The loan was in the end made despite reservations strongly expressed by the Risk Management Department, as a result of which:

   - The Bank never obtained sufficient information on Mr. Chau, in particular about his net worth and its accessibility and so, his personal guarantee was not meaningful;

   - The Bank had no direct charge over any cashflow to assure it of repayment but had to rely on cash derived from asset injections into Shanghai Land to enable it to be repaid, but these depended on Mr. Chau's good faith and honesty, and his and Shanghai Land's ability to comply with the Listing Rules and the Code on Takeovers and Mergers. There was no way that the Bank could be fully assured that the asset injections would actually be made and the Bank's external legal advisers, Messrs. Koo & Partners, advised the bank officials concerned that the Bank could not in the circumstances be fully protected;

   - The Bank accommodated Mr. Chau's request for not taking legally enforceable rights over properties available for injection into Shanghai Land by way of either legal or equitable charge, upon his representation that the injection of such properties may thereby be deemed "connected transactions" under the Listing Rules;

   - The Bank was thereby put into the position of having to rely on Shanghai Land shares as its core collateral. To protect the value of these shares, it had to devise complicated and resource intensive arrangements to protect assets of Shanghai Land by ensuring that Shanghai Land would not incur substantial liabilities or dissipate its cash assets. This further increased reliance on Mr. Chau's good faith and honesty, since no foolproof protection system could be devised;

   - The inability to resolve fully these issues made the loan a high risk one, requiring intensive and costly monitoring as risk mitigation measures and it exposed the Bank to reputational risk.

II. The New Nongkai Loan *(continued)*

Errors of Judgment *(continued)*

(ii) The Bank's officers involved in the processing of the loan could reasonably, and did, rely on the fact that at the time the loan was being considered, those acting for Mr. Chau were competent investment bankers in good standing, registered as securities market practitioners or highly reputable law firms. These professional advisers could reasonably be relied on not to advise Mr. Chau to involve himself in any unlawful or irregular activity. The Bank's officers were also careful to ensure that in the loan documentation, Mr. Chau and parties to the documentation were expressly required to observe all relevant rules and regulations, including the Listing Rules and the Code on Takeovers and Mergers. The bank officials involved in this loan did seek advice, from time to time, from one of the Bank's external legal advisers, Messrs. Koo & Partners, and they acted in accordance with the advice given;

(iii) However, they failed to appreciate that their accommodation of Mr. Chau's requests for the purpose of surmounting obstacles in the Listing Rules could easily expose the Bank to public speculation that they may have facilitated Mr. Chau in evasion of the Listing Rules, whether or not there had been evasion. They also failed to appreciate the difficulty that the Bank would face in defending itself in public, because it would be bound by client confidentiality. Moreover, as the Special Committee has found, Mr. Chau never told the officers concerned how he would comply with relevant Listing Rules or the Code of Takeovers and Mergers nor were the officers party to, or had any knowledge of the contents of, any communications between Mr. Chau or those acting on his behalf with the Stock Exchange or the Securities and Futures Commission. Having been kept in the dark and with their sketchy knowledge of Mr. Chau and his background, the Bank's officers exposed the Bank to reputational risk, with no contingency mitigation plan;

(iv) The Bank's officers' lack of appreciation that the accommodation of Mr. Chau might expose the Bank to reputational risk stemmed from their inexperience in and lack of understanding of the operation of the Listing Rules and the Code on Takeovers and Mergers. They had to rely on the representations of Mr. Chau and his advisers, who clearly treated the Bank as a negotiating counterparty and therefore only gave information on what they judged the Bank needed to know. If the Bank's officers had had a good working knowledge of the Listing Rules and the Code and related practice, they most probably would have been more inquisitive and may thereby have either not extended the loan or have required stringent conditions to put beyond doubt any possibility of exposure to reputational risk, and priced in the costs of compliance;

(v) The former Chief Executive was the actual Chairman of the Credit Committee, but as a matter of practice, delegated the chairmanship to Mr. Or. Mr. Or outranked everyone on the Committee except the Deputy Chief Executive (Retail Banking). As the person tasked with delivery of business performance in the Corporate Banking Department, Mr. Or saw his prime responsibility as getting business for the Bank if he judged the risks could be controlled. Mr. Mao, the Chief Risk Officer, was junior in rank, and whilst he constitutionally had a right of veto, did not feel sufficiently bold or justified in the circumstances to exercise this power. This situation of leaving the chairmanship of the Credit Committee in the hands of the head of a business generation department of the Bank lessened the effectiveness of the workings of the Credit Committee which depended upon the free expression of different views about risk;

(vi) This defect in the composition of the Credit Committee was in fact pointed out by the then Chairman of the Risk Management Committee (Mr. Liu Mingkang, who was also Chairman of the Board) on 21 March 2002 when he asked the then Chief Executive (Mr. Liu Jinbao) to consider putting in place a system of credit assessment similar to that now in the process of being put in place (as to which see paragraph 25 below). The then Chief Executive however on 26 May 2002, proposed to the then Chairman that whilst he agreed with the proposal, its implementation should be postponed until after the risk management procedures put into place following the merger had settled down.

II. The New Nongkai Loan *(continued)*

The Lessons Learnt

8. Although the credit approval procedure was followed in the decision to lend, and decisions were made expeditiously, good judgment did not prevail. The key risk issues emerged impressively fast, but the Bank allowed itself to be pressured by Mr. Chau, who stated that other banks were willing to finance him and that he was under a tight timetable to close a deal with the majority shareholders of the target company who had other suitors. In the haste to meet Mr. Chau's timetable, the key risk issues identified were not sufficiently addressed. Bank Officials sought to address the credit risks involved by seeking to protect the cash and contain the incurring of liabilities of the listed company being acquired, rather than seeking to identify cash flows that could directly be applied to repay the loan. This gave rise to difficult issues in relation to the listing requirements applying to the target company, and heavy reliance was placed on outside legal advice, as well as Mr. Chau's representations and his good faith and honesty and his ability to comply with the rules. The solutions adopted were complex and costly and the reputational risks were not adequately addressed. In the end, the Bank was exposed to credit and reputational risks which were disproportionate to the rewards.

9. It was not good management practice to delegate to Mr. Or chairmanship of the Credit Committee, when he was in charge of business generation. The strong tradition of respect for seniority in the Bank makes it difficult for staff to voice dissenting views against the wishes of more senior officers, and the former Chief Executive not only should have known this but had the problem directly drawn to his attention by the then Chairman of the Board (Mr. Liu Mingkang) as early as 21 March 2002, before the loan was made.

10. This episode also illustrates that bank management was not sufficiently sensitive to regulatory compliance issues particularly those relating to the securities markets. As BOCHK will most likely be involved in financing future takeovers of listed companies, the staffing of the Compliance Division should be reviewed to ensure that the Bank does have a Compliance Officer capable of providing in-house advice on securities markets compliance issues in future lending transactions.

11. In conclusion, the underlying issues in relation to the making of the loan are not so much defects in the procedure for approving credit as the inadequacy of the judgments and experience of the key people involved. The Special Committee believes the procedure could have worked well if it had been operated by more experienced officials, and the principles and values of risk management set out on pages 124 and 125 of the 2002 Annual Report had effectively bedded down. In particular, the problems occurred because the imbalance between business generation and risk management (which was pointed out by the then Chairman of the Board) was not addressed in a timely manner.

Who was Responsible

12. The New Nongkai loan proposal was clearly a substantial loan. At around HK$1.77 billion, it was about 4% of the Bank's regulatory capital. It was not large enough to need to be reported to or approved by the Board, but its size did exceed the authority of the Deputy Chief Executive for Corporate Banking, Mr. Or, and so needed clearance through the Credit Committee, and final endorsement by the then Chief Executive. All the members of the Credit Committee share responsibility for this loan, but the key senior figures in the Bank as regards this transaction, were Mr. Liu Jinbao, the then Chief Executive, Mr. Or and Mr. Mao, the Chief Risk Officer.

13. On the evidence available to the Special Committee, it found no cause to believe that any of these three key senior officials involved in the loan were motivated by anything other than what they saw as the Bank's best interests. The Special Committee notes that Mr. Chau made an effort to deliver according to the terms of the loan, and did repay a substantial portion of it. Indeed, if the Extraordinary General Meeting of Shanghai Land, called for 3 June 2003 but was then postponed, had approved the proposed further asset injection, only a very small amount of the loan would remain outstanding. Current recovery action indicates a possibility that the Bank may make substantial recovery perhaps with little or no loss to the Bank.

II. The New Nongkai Loan *(continued)*

Who was Responsible *(continued)*

14. Notwithstanding this, prudent banking practice requires the exercise of good judgment at the beginning and it must be noted that the adverse publicity surrounding this loan has damaged the standing and reputation of the Bank. Of the three key senior officers involved in the making of this loan, the Special Committee finds for the reasons set out in this section of the Report, that the former Chief Executive and Mr. Or should bear responsibility for the errors of judgment made in the course of approving the loan. The Special Committee does not find that Mr. Mao should bear responsibility for making of the loan. Once the loan was made, it was intensively monitored by management. The Special Committee make no criticism of the bank officials involved in this phase of the loan.

15. Mr. Or, as Deputy Chief Executive for Corporate Banking, led for BOCHK at the initial meeting when BOCI proposed the New Nongkai bridging loan, on or about 18 March 2002. He chaired the crucial Credit Committee meetings of 22 and 27 March 2002, which ultimately approved the proposition in principle, and he signed the offer letter on 27 March. He argued strongly for the loan at subsequent meetings, despite continuing reservations from the Risk Management Department, which were never fully satisfied.

16. As the Head of a business generating department of the Bank, Mr. Or could be expected to advocate a loan which he perceives to be substantially rewarding for the Bank. However, as one of the most senior managers of the Bank, it is expected that he should balance risks carefully against reward, and in particular, he would be expected to guard the Bank against reputational risk. The Special Committee therefore finds that Mr. Or had failed in this instance to discharge his duties at a level expected of a deputy chief executive of the Bank, in that:

    (i) He failed to commission sufficient inquiry into the background of Mr. Chau and his businesses as befits a loan of such size and complexity;

    (ii) In his anxiety to capture the business for the Bank, Mr. Or accommodated several requests made by or on behalf of Mr. Chau which served to weaken the collateral position of the Bank, and unintentionally exposed it to possible speculation that the Bank may have facilitated him if he committed a breach or evasion of the listing rules or the Code on Takeovers and Mergers;

    (iii) The Bank had to establish a complex set of loan administration arrangements which were costly and could not be expected to ensure full and timely recovery of the loan;

    (iv) He failed to heed the reasonable warnings of the Risk Management Department and thereby exposed the Bank to credit and reputational risk disproportionate to the rewards deriving from the loan.

II. The New Nongkai Loan *(continued)*

Who was Responsible *(continued)*

17. Mr. Mao, Chief Risk Officer and Head of the Risk Management Department, was the most senior risk controller involved in events leading to the making of the loan. He attended the initial Credit Committee meeting on 22 March, which did not accept the recommendation of the Risk Management Department to reject New Nongkai's proposition. At the conclusion of the meeting, Mr. Mao indicated that after the reservations expressed by the Risk Management Department have been addressed, the approval of the loan should be discussed again and he made sure that this was reflected in the minutes of this Credit Committee Meeting. Therefore, although the minutes relating to this loan commenced with the words "agreed in principle", he believed the Credit Committee's approval in principle was conditional on measures to satisfy the Risk Management Department's concerns, and the Committee indeed returned to those concerns in subsequent meetings before the loan was approved. At the next meeting of the Credit Committee held on 27 March 2002, Mr. Kwok Chak Wah on behalf of the Corporate Banking Department briefed the Credit Committee on methodologies to address the concerns expressed on 22 March. The key papers which were sent to this meeting were all dated 27 March 2002 and so members of the Credit Committee did not have much time to consider this loan. Mr. Mao was away on Bank business (the Special Committee finds no cause to believe that this was done to avoid having to attend the meeting) and his deputy at the time, Mr. Chu Kar Wing attended the meeting. Members of the Credit Committee were sufficiently satisfied at this stage to have given approval for an offer in principle to be issued by the Bank to Mr. Chau and indeed one such letter was issued that very evening. Further headway was made to address the concerns of the Risk Management Department, but these concerns were never fully satisfied.

18. Mr. Mao raised with Mr. Or on several occasions whether the Bank might not go ahead with the loan but Mr. Or indicated that unless there were good reasons, the Bank's reputation would be seriously damaged if it were to renege on an offer when there were no hard evidence to support its decision. The Special Committee would observe that after 27 March, when the offer letter was issued, it would indeed be difficult for the Bank to renege without hard evidence. Mr. Chau was very much seen at that time as an important, though mysterious Shanghai businessman. Mr. Mao briefed the former Chief Executive on a number of occasions about his concerns, but the former Chief Executive did not intervene. At the Credit Committee meeting held on 18 April 2002, Mr. Mao was recorded to have expressed concerns over Mr. Chau's background and the decision of the Credit Committee recorded, most probably, at the insistence of Mr. Mao, that as a condition of the approval of the loan, Mr. Chau's net worth must among other things be ascertained. The Bank never got to know Mr. Chau's net worth. Worries about reputational risks were expressed at this meeting and duly recorded in the minutes. These minutes were sent to the former Chief Executive on probably the 19 April 2002 so that his endorsement of the loan might be given. He gave his endorsement on 22 April 2002 and the loan documents were signed on 23 April 2002.

19. Although the procedures of the Credit Committee allows the Chief Risk Officer to exercise a veto, it would in the view of the Special Committee be unrealistic to expect Mr. Mao to do so after 27 March, nor would it be reasonable to expect him to exercise the veto on 22 March when the loan came up to the Credit Committee for the first time. After 27 March, a veto would have been meaningless, since the offer had been made to Mr. Chau. The only person who can balance the overall reputation of the Bank against the risks of not proceeding with the offer was the former Chief Executive. Mr. Or was unwilling to renege on the offer and so, Mr. Mao, rightly in the view of the Special Committee, brought up his concerns with the former Chief Executive who in the end failed to intervene.

20. The former Chairman, Mr. Liu Mingkang, did bring up the concern of potential conflict between the heads of business generation and risk management in the Credit Committee but the former Chief Executive decided not to implement the Chairman's proposals. The former Chief Executive's reasons, given in an office memo dated 26 May 2002, for not doing so was that he wished the systems and staff to first settle down following the merger. Whilst this was an apparently reasonable stance, the then Chief Executive was put on clear notice as early as 21 March 2002, that there was an "unhealthy imbalance" between business generation and risk management in the credit approval process. The former Chairman's proposal was eventually considered and approved by the Risk Management Committee of the Board in March, 2003 and has since been further fine-tuned and is in the process of being implemented.

II. The New Nongkai Loan *(continued)*

Who was Responsible *(continued)*

21. Accordingly, the Special Committee does not consider that Mr. Mao should bear responsibility for the loan, any more than as any other member of the Credit Committee. As a member of the Credit Committee, Mr. Mao raised appropriate concerns over the loan. Other members of the Committee also recommended risk mitigation measures. Therefore, the system of risk management in the Bank, despite this incident, was intact and worked as intended except for the imbalance between business generation and risk management. However, the system cannot replace the judgments of the top management in any organisation and this brings us to our findings in relation to the former Chief Executive.

22. Mr. Liu Jinbao, then the Chief Executive, gave written endorsement of the decision to lend on 22 April 2002, but was aware of it before then, having been briefed by Mr. Or and Mr. Mao. The Special Committee finds that he failed properly to discharge his duties as Chief Executive in this instance, for the following reasons:

    (i) He did not seek to influence or intervene in the decision making process of the New Nongkai loan, although it was clear that the Risk Management Department had serious and unresolved concerns about it, about which the Chief Risk Officer had on several occasions briefed him and these concerns were fully recorded in the minutes of the Credit Committee meeting of 18 April 2003 which were submitted to him for endorsement of the loan;

    (ii) When he did endorse the loan proposal, on 22 April, he added a condition that the Bank should observe the "Know your customer rule" by ensuring that it knew the full background of Mr. Chau before the disbursement of the loan. He ought to have known that this condition would be of scant value to the Bank. He knew by then that the Bank was committed — in principle at the very least — to lend, and he must have been aware that once his endorsement was given, the formal loan agreement to fulfill its commitment would be signed almost immediately. Once that agreement had been signed, it would be extremely difficult if not impossible to withhold the disbursement;

    (iii) He should have appreciated that Mr. Or's position as de facto Chairman of the Credit Committee created an imbalance between business generation and risk management which would impede its effective working when dealing with a loan proposal which Mr. Or advocated, such as the New Nongkai loan, and he should have been alert to the possibility of Mr. Or exercising a decisive influence on the other members of the Committee, all of whom (except Mr. Lam, the other Deputy Chief Executive) were outranked by Mr. Or. The imbalance in the system was in fact brought to his attention by the former Chairman of the Board on 21 March 2002.

Actions Already Taken or to be Immediately Taken

23. The Special Committee recommends that the Board accepts Mr. Or's application to take early retirement. It is understood that Mr. Or, who has completed more than 30 years of service with the Bank, has applied for early retirement, as he was entitled to do. Although Mr. Or's error of judgment has resulted in reputational damage to the Bank, the signs are encouraging that the Bank may well make substantial recovery, perhaps with little or no loss. The Bank has incurred substantial cost in the aftermath of the loan in the making of this review but the lessons learnt from this review will undoubtedly make the Bank a stronger institution. The Special Committee would make the further observation that in the course of this review and the interviews with staff and management, it was apparent that Mr. Or was held in high regard by his colleagues for his devotion to duty. His representations to the Special Committee were thorough and dignified, and he readily accepted responsibility. This is a commendable display of a strong sense of personal accountability to the Bank that is entirely consistent with the high regard held by his colleagues for him.

24. The Special Committee regrets that it has not been able to address tentative findings to Mr. Liu Jinbao and therefore did not have the benefit of his representations before making this Report to the Board. Mr. Liu Jinbao has returned to Beijing and is no longer working for BOCHK, the Special Committee recommends that the Board consider addressing a note of the findings of this Committee to BOC for such action as BOC deems fit.

II. The New Nongkai Loan *(continued)*

Actions Already Taken or to be Immediately Taken *(continued)*

25. The Special Committee also notes that the procedure for approval of credits, such as the New Nongkai loan, which exceed the delegated authority of the head of the Corporate Banking Department but are below the level for which Board approval is required, has already been reviewed by management. The Credit Committee is being replaced by a new procedure, incorporating a new Credit Assessment Committee. The key change is that a proposal which exceeds the individual authority of relevant General Managers must proceed through the new Committee. The Chief Risk Officer will have the right to call for the Committee to review its recommendation, either for or against an application, but the Committee's advice will constitute the last word. If its advice is to approve the proposal, this forms a recommendation to the Deputy Chief Executive in charge of that business or Chief Executive, depending on the amount of the loan. If its decision is to reject, the proposal is abandoned, as neither the Deputy Chief Executive nor Chief Executive shall have the right to over-rule the Committee's rejection. This new procedure addresses the issue of conflict of interest in the credit approval process. In the longer term, the Special Committee regards a more important safeguard as being the inculcation of greater willingness to debate and challenge ideas and proposals more openly, with more regard to their intrinsic merits than the seniority of who is proposing them.

26. The Special Committee recommends that the Board reviews the levels of loans which should be approved by the Board or its Risk Management Committee, bearing in mind the need to balance large financial exposures against undesirable restraints on the freedom of management. The other risks, notably reputational risk, to which this loan has exposed the Bank, are largely unrelated to its size. What is needed in the view of the Special Committee is to embed more deeply the values and principles of risk management already adopted by the Bank. In the next sections of this Report, the Special Committee makes a series of recommendations to the Board which will help attain this objective. These recommendations are largely derived from the review undertaken by KPMG.

III. Stronger Foundations for Higher Standards

Continuing Integrity of Credit and Risk Management Process

27. The KPMG review was one of the most comprehensive Section 59 reviews ever conducted in Hong Kong banking history. The Report is in four volumes which document and consider in detail the internal workings of the corporate banking credit and risk management processes, the high level controls of the Bank and a review of the quality of China related loans as well as other loans according to criteria set out in the Bank's Announcement of 17 June 2003. KPMG's Report recognises that the Bank has only in the last 18 months become the amalgam of 12 smaller banks, with 13,000 staff and whilst much has been achieved in the implementation of key credit approval and risk management systems, the Bank can usefully take the opportunity to make enhancements to these systems. Based on the KPMG Review and its own observations, the Special Committee is satisfied with the continuing integrity of the Bank's credit approval process and systems of risk management and internal controls. There is no crisis of risk management but it believes that it is worth reiterating the point that the key issues raised by the New Nongkai loan are more about people, their ability to adjust to a new environment, to make competent judgments, their motivation to act on them, and their management, than about processes and systems. Systems can be put in place but people operate them. The "people" issues are therefore the priority.

28. This is not to say that policies, procedures and practices are unimportant. KPMG have undertaken a detailed comparison of those of the Bank against the Bank's own policies and HKMA guidelines. They identify instances where one or other are not precisely met in all respects. The Special Committee notes that in most cases it is the Bank's own policies which are not fully met. The HKMA guidelines are expressed at a high level and therefore it is important to ensure that they are observed in the spirit they are written. None of the shortfalls are so serious as to warrant any action other than prompt rectification. The Bank will need to agree a rectification programme and timetable with HKMA, which Internal Audit Department should monitor, reporting any problems to the Audit Committee.

29. KPMG make a number of other detailed observations and recommendations designed to embed better risk management within the Bank, and to improve the way it actually operates, even though HKMA guidelines are met. The Special Committee notes that these recommendations are welcomed by management. It concludes that management should take these forward to implementation, and justify to the Board (through its relevant Committees) the exceptions where it does not agree with the recommendation, or propose alternative arrangements.

30. These observations and recommendations by KPMG reflect its view that the agenda is incremental improvement, not immediate radical reengineering, though some items should command priority. This confirms the view of the Special Committee that there is no crisis of risk management brought to the surface by the New Nongkai loan or the KPMG Review but at the same time, this should alert management to the need for a sense of urgency lest the momentum of reforms should suffer.

31. KPMG note that management has extensive plans to modernize bank wide key operational systems, which imply significant changes in working practices, notably closer coordination and cooperation between different parts of the organisation. They note that these centre on effective implementation of a number of key, and interlinking, IT projects. They comment "*each of these projects is highly significant in its own right, but in combination they represent a formidable challenge*". They propose the establishment of a Programme Management Office to monitor and control progress on these projects, and to manage their interaction more effectively. The Special Committee agrees that these projects must not be allowed to fail, and believes this should be addressed in improvements to management structure.

32. The Special Committee based on the KPMG Review and its own observations, makes the recommendations contained in the next two sections so that the Bank may have a management and corporate governance worthy of a first class international bank.

III. Stronger Foundations for Higher Standards *(continued)*

Enhancing Management Structure

33. The Special Committee notes that the Bank carries a heavy workload of establishing the systems and processes arising from the merger. Competition in the market place is fierce. The key immediate risks for the Bank lie in the Bank allowing itself to slip into a disadvantageous mismatch between the skills and experience, working culture and practice of the Bank compared with its principal competitors, which if not addressed in a timely manner will result in the erosion of its business franchise, despite the natural advantage it enjoys of association with Mainland China. The Special Committee therefore believes that, although the Bank is on track in the programs which it has been pursuing since the merger to establish new systems and improve existing ones, this Review provides an opportunity to lay firmer foundations for reaching higher standards in the future.

34. Changing working practices and systems will not work unless the motivation and behaviour of the people involved allows the changes to have their intended effect. The recommendations by the Special Committee and their reception by the Board must demonstrate and reinforce the motivation and behaviour desired of management and staff, and deter continuation of undesired practice.

35. The Special Committee believes that the best place to start is to place a powerful — ie. world class — appointee into a new role of Chief Operating Officer. His remit would be to help the Chief Executive to co-ordinate the many programs of change already under way and deliver a comprehensive operational platform which meets best international practice. This is in line with the KPMG's suggestion of the formation of a Project Management Office. The Special Committee feels that the importance of creating a world class operational platform deserves a high caliber candidate at a level similar to that of the existing deputy chief executives. The Committee believes this position should be filled by competition, open to outside as well as inside candidates. A competitive remuneration package will have to be offered. It is important that the Chief Executive leads the process of making such an appointment. The appointee's first priority should be to instill an urgently needed bank wide perspective at a high level on the major IT projects referred to above. These projects are expensive, critically important to improving work processes, and themselves a key agent of change in working culture.

36. KPMG rightly observe that raising the profile of the Chief Risk Officer would also help embed risk consciousness throughout the Bank. The Special Committee recommends that the importance of risk management should be elevated by ranking the Head of Risk Management alongside the Heads of the revenue generating departments. His remit would be to ensure the Bank maintains best practice in credit, market, operational, legal and compliance risk control. Again, a world class appointee is required, and the appointment should be made following the same process as that recommended for the new Chief Operating Officer. The position could be titled Director of Risk, in recognition of its seniority and importance.

37. In recommending the creation of the two posts of Chief Operating Officer and Director of Risk, the Special Committee wishes to make it clear that this does not imply any criticism or should in any way reflect adversely on the staff performing similar functions within the Bank. The Special Committee's hope behind these recommendations is to afford the Bank the opportunity to obtain by open competition, world class candidates for these functions at an enhanced level and thereby deepen and accelerate the process of change started by the merger and listing of the Bank. The Chief Executive is fully in support of these recommendations. The Special Committee wishes to stress that the Chief Executive will need the fullest support from the Board so that he may have the necessary resources to implement these recommendations. The Chief Executive will have to motivate management and staff to take ownership of these recommendations and he can only do this if he is able to design with the Board a comprehensive human resources and remuneration policy conducive to identifying and retaining the best candidates in all other key positions in the Bank. In this regard, the Special Committee does not believe that all this will increase overall costs. What is needed is the right compensation for the right people and a level of staffing that is supported by the business generated.

III. Stronger Foundations for Higher Standards *(continued)*

Recommendations to Enhance Corporate Governance

38. KPMG make a number of suggestions and recommendations about the Board committee structure, nominations, agenda management, self-assessment, and other matters of corporate governance. These recommendations are broadly in line with thinking already underway in the Board and are therefore worthy of implementation, but some command higher priority than others.

39. The most immediate priority relates to independent non-executive directors, following Mr. Chia's retirement. BOC provides the majority of non-executive directors, consistent with its majority shareholding. That leaves four independent non-executive directors (now three, with Mr. Chia's retirement) to provide any experience and independent perspective not furnished by the BOC nominees. Mapping the skills and experience of the present non-executive directors against the challenges now being faced by the Bank suggests that more experience in corporate governance, supervising change management, IT related project management, and banking related risk management would be invaluable. If it cannot be found in one candidate, perhaps the recruitment of an additional independent non-executive director should be considered.

40. KPMG's comments about the Board's workload should also be considered an urgent matter. The Chief Executive should consider with his management team measures to ensure that future Board papers should be more succinct and propose a template of key performance indicators to assist the Board in its oversight of management. KPMG have suggested that the Board should establish an Executive Committee. This is intended to enable the Board and its other committees to focus more on strategy and oversight of the business, and improve communication between the Board and management. The Special Committee recommends that the Board tasks the Chief Executive to conduct a study on the need and feasibility of an Executive Committee and if thought fit, include in his report, the full details of the terms of reference, membership and operation of this Committee and report to the Board within six months, bearing in mind the need to first enhance the management structure.

41. It has been suggested by KPMG and others to the Special Committee that the appointment of additional executives to the Board, will act as a means of fostering a bank wide sense of responsibility in the top executive team. The Special Committee feels that this suggestion deserves careful consideration and recommends that the Board should task the Chief Executive to study this and report his findings to the Board at the same time as his report on the proposed executive committee.

42. A further matter relates to the Board's oversight of Compliance. At present, this is achieved through a sub-committee of the Audit Committee comprised of Bank executives and a co-opted member of BOC. The Special Committee recommends that a better home for this responsibility is the Risk Management Committee, reflecting the fact that Compliance is concerned with the control of regulatory risk. We also propose that the Chief Executive should undertake a review as to whether the Legal and Compliance Department has the capability of providing compliance support on securities markets matters in relation to future lending transactions of the Bank.

43. The Special Committee is concerned that the Bank's internal audit arrangements are not adding as much value as they could. In particular, the Special Committee questions whether there is sufficient audit of management processes identified as critical to the operations of the Bank, not only to be sure they are working according to the stated procedure, but also that the procedure is achieving its intended objective. The Special Committee recommends that to ensure that the Board is assured that it is getting the fullest value from internal audit, it should consider tasking the Audit Committee to commission a more detailed review of the internal audit process against international banking best practice.

44. Finally, it is also recommended that the Chief Executive should be tasked to assess KPMG's other suggestions and recommendations for their value in promoting operational efficiency and effectiveness, reporting to the Board within 3 months.

III. Stronger Foundations for Higher Standards *(continued)*

Conclusion: Reaching for Higher Standards

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

46. The priority is to ensure that the Bank has an enhanced top management team to support the Chief Executive and in this respect, it is important to select, as soon as possible, the new Chief Operating Officer and Director of Risk. These should be persons with sufficient experience to bring international best practice into the Bank, and with the right qualities to bring forward the ambitious program of change that the Bank has already committed to undertake in its merger plans.

47. The next priority is to make sure that the Bank has the human resource and compensation policies which are conducive to ensuring that the best candidates are placed and retained in all key positions in the Bank. Only then, can the Bank truly aspire to be a bank which is capable of operating under best international practice.

48. Board leadership will play a critical role in the effort to achieve best international practice. The Chief Executive should be given the fullest support by the Board to motivate the staff to implement the many recommendations made in this Report. It is only through the joint effort of the Board, the management and the staff that the Bank may emerge as a stronger institution, ready to reach for higher standards.

Dated this 5th day of September, 2003

(Sd.) Anthony Francis Neoh
Anthony Francis Neoh, Convenor

(Sd.) Victor Kwok King Fung
Victor Kwok King Fung, Member

(Sd.) Weijian Shan
Weijian Shan, Member

(Sd.) Richard Farrant
Richard Farrant, Special Adviser

(Sd.) Jason Chi Wai Yeung
Jason Chi Wai Yeung, Secretary

Appendix 1

Terms of Reference of the Special Committee

(as approved by the Board of Directors on 17 June 2003)

1. The Board has resolved to set up the Special Committee with Mr. Anthony Neoh, the Senior Adviser, as the convenor and Messrs. Victor Fung and Weijian Shan, both independent non-executive directors, as its members. The Company Secretary, Mr. Jason Yeung will act as the Secretary to the Committee.

2. The terms of reference of the Special Committee are as follows:

   (i) To undertake a comprehensive review of the credit approval process, credit risk management process and related internal control mechanisms for the Bank for corporate lending.

   (ii) To undertake a review of the compliance process and identify any weaknesses in the compliance process based on its examination of the audit report undertaken for the Section 59 Review as well as its own review of the compliance procedures and their operation.

   (iii) To undertake a review of the Corporate Governance of the Group.

   (iv) To submit such other observations and recommendations as they shall deem fit, based on their review of the Section 59 Review and their own examination of the credit approval, risk management, internal controls and compliance processes of the Bank.

   (v) To submit a written report to the Board through the Audit Committee within 2 weeks of the completion of the Section 59 Review report.

Appendix 2

Abbreviations and Definitions

In this Report, unless the context otherwise requires, the following terms shall have the meanings set out below:

"Bank" or "BOCHK"	means Bank of China (Hong Kong) Limited, a company incorporated in Hong Kong and an authorised institution pursuant to the Banking Ordinance;
"Board"	means the Board of Directors of BOCHK;
"BOC"	means Bank of China, the ultimate holding company of BOCHK;
"BOCI"	means BOC International Holdings Limited;
"HKMA"	means the Hong Kong Monetary Authority;
"Listing Rules"	means the Rules Governing the Listing of Securities on the Stock Exchange;
"Mr. Chau"	means Mr. Chau Ching Ngai, the Chairman of Shanghai Land;
"Mr. Kwok"	means Mr. Kwok Chak Wah, the Head of Industrial and Commercial Division of Corporate Banking & Financial Institutions Department of the Bank;
"Mr. Liu"	means Mr. Liu Jinbao, the former Chief Executive of the Bank;
"Mr. Liu Mingkang"	means former Chairman of the Bank who left office on 28 May 2003;
"Mr. Mao"	means Mr. Mao Xiaowei, the Chief Risk Officer of the Bank;
"Mr. Or"	means Mr. Or Man Ah, the Deputy Chief Executive for Corporate Banking of the Bank;
"New Nongkai"	means New Nongkai Global Investments Limited, a company incorporated in the British Virgin Islands, the shares of which are beneficially owned by Mr. Chau;
"New Nongkai loan" or "loan"	means the loan advanced by BOCHK to New Nongkai;
"PwC"	means Messrs. PricewaterhouseCoopers, the auditors for the Bank;
"Receivers"	means Messrs. Stephen Liu Yiu Keung and Kenneth Yeo Boon Ann, joint and several receivers appointed to Shanghai Land;
"Section 59"	Section 59 of the Banking Ordinance which empower the HKMA, after consultation with an authorised institution, to require that institution to submit a report by an auditor on matters specific by the HKMA;
"Shanghai Land"	means Shanghai Land Holdings Limited, a company listed on the Stock Exchange;
"Stock Exchange"	means the Stock Exchange of Hong Kong Limited.

Appendix 3

Summary of the Findings of Moores Rowland

Introduction

Moores Rowland's review and report was commissioned by the Bank in an engagement letter dated 24 June 2003. It covers loan exposures of the Bank to the Chau Group. Any findings and recommendations made are in respect of the review of the Chau Group, and it should not be assumed that they can be extrapolated to all loans granted by the Bank.

Moores Rowland's review comprised principally examination of documents and files provided by the Bank, and interviews with staff and other persons involved. These procedures do not constitute either an audit or a review made in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants, and, consequently, no assurance is expressed.

Moores Rowland's report inevitably contains information about the Bank's customers — notably Mr. Chau himself — that is protected by client confidentiality. This summary excludes such information.

The following are extracts from the Moores Rowland report's summary of findings and conclusions which do not contain confidential client information:

Conclusions

"In relation to the approval and granting of the Bridging Loan, our conclusions are as follows:

(a) The Bridging Loan was granted by the Credit Committee of the Bank, which had the appropriate authority to approve a loan of such size according to the Bank's credit approval procedures and delegated authorities then applicable.

(b) Whilst it could be said that the Bridging Loan was approved and granted in compliance with the established policies of the Bank in a formal sense, since there is evidence to indicate that all relevant policies were considered, we have identified the following shortcomings:

   (i) The risks associated with the Bridging Loan, including those identified by the Risk Management Department right from the beginning, were not adequately addressed, because of the perceived adequacy of the cash control and extraction mechanism designed under advice by the Bank's legal advisers. The legal and regulatory implications of the cash control and extraction mechanism were however not adequately understood and addressed.

   (ii) The Bank gave inadequate consideration to the KNOW YOUR CUSTOMER policy.

   (iii) In its attempt to structure the Bridging Loan in such a way that would balance the Bank's interest and the customer's desire to surmount regulatory obstacles arising from the Listing Rules, the Bank's senior officers had inadequate alertness to matters that might expose the Bank to reputation risks in the context of Credit Risk Management Fundamental Principle No. 4 "*Operate within the boundary of the law and regulations, upkeep reputation (依法經營維護聲譽)*".

In relation to the post-lending monitoring and control of the Bridging Loan, our conclusions are as follows:

(a) The risks associated with the Bridging Loan were adequately controlled and monitored in accordance with the special arrangements between the Bank, New Nongkai, Shanghai Land and the directors of Shanghai Land.

(b) The Bridging Loan should have been downgraded to "Special Mention" at 31 May 2003 following the reported detention of Mr. Chau, who was pivotal in the asset injection and cash extraction plan, and following the significant drop in the market value of the pledged shares, which triggered an event of default that resulted in the set-off of the deposit of HK$50 million pledged by the Borrower.

Appendix 3 *(continued)*

Summary of the Findings of Moores Rowland *(continued)*

Conclusions *(continued)*

(c) No provision needed to be made at 31 May 2003 for the Bridging Loan, as there was no evidence that the Bank would suffer any loss in relation to the loan.

Our conclusions in relation to the exposures to the Chau Group are as follows:

(a) On the basis of the procedures we applied, we conclude that the Bank has properly identified the exposures to other members of the Chau Group.

(b) These exposures were granted in compliance with the established policies and procedures and delegated authorities of the Bank then applicable.

(c) The mortgage loan granted to Mr. Chau and Ms. Mo was still current at 31 May 2003 but should have been downgraded to "Special Mention" at 31 May 2003 following the reported detention of Mr. Chau. Further downgrading should be considered should circumstances deteriorate further.

Recommendations

Based on our review of the Bridging Loan and other exposures to the Chau Group, we have made the following recommendations in respect of the operation of the Credit Committee for consideration by the Board of Directors in conjunction with recommendations to be made by KPMG from their overall review of the Bank's credit procedures and corporate governance features:

(a) Restructuring the Credit Committee to ensure that credit approval decisions are free from the "advocacy risk" of the business departments initiating the relevant credit applications.

(b) Changing the appeal system whereby the Credit Committee should submit any appeals against vetoes made by the Risk Management Department to the Risk Management Committee of the Board, instead of to the Chief Executive, thereby removing any undue pressure on the Risk Management Department.

(c) Setting timetable for the distribution of agenda and supporting papers in advance to enable Credit Committee to better prepare for meetings.

(d) Removing trivial matters from the agenda of the Credit Committee so that the Credit Committee may concentrate on important credit decisions.

(e) Considering obtaining second opinion on important legal issues.**"**

Appendix 4

Summary of the Findings of KPMG

Introduction

KPMG's review and report was commissioned by Bank of China (Hong Kong) Limited ("the Bank") in an engagement letter dated 7 July 2003. It covers high level controls exercised by the Board; credit approval processes; credit risk management framework and internal control mechanism within the Corporate Banking & Financial Institutions Department of the Bank; and credit file review of loans meeting criteria as set out in the Bank's announcement of 17 June 2003. These criteria exclude any loans to Mr. Chau or related parties to him, which have been reviewed by Moores Rowland. The full report has four volumes:

- executive summary;
- high level controls exercised by the Board;
- credit risk management framework; and
- credit file review.

The volumes on high level controls exercised by the Board and credit risk management framework contain a summary of the key HKMA supervisory guidelines relevant to each volume; a summary of the Bank's control procedures in place as at 31 May 2003; findings based on a comparison of the Bank's control framework against the relevant modules of the Supervisory Policy Manual and Guidelines issued by the HKMA and against the Bank's established policies and procedures; and recommendations reflecting further improvements that could be made to enhance the Bank's control framework. The volume on credit file review sets out the details of the sample selected based on the HKMA's criteria, an analysis of proposed loan classification and provisioning and other findings from review of customer loan files.

KPMG's review comprised interviews with senior and key line management; review of key documentation and procedures manuals; and review of reports of internal and external auditors and regulators' examination reports for the period from 1 October 2001 to 31 May 2003. Their work was based on obtaining an understanding of the control procedures in operation as at 31 May 2003 by enquiry of management, compliance testing and review of documents supplied to it.

KPMG's work did not cover credit policies, procedures and controls in respect of the Bank's treasury or retail banking businesses; or the credit risk management framework and internal controls of the Bank's PRC branches and subsidiaries.

As agreed with the Bank, KPMG's work did not constitute an audit, and therefore does not provide the same level of assurance as an audit; and the scope of work was such that KPMG would rely upon information and explanations given to them without independent verification or authentication. Accordingly, KPMG have not established the completeness or accuracy of information and explanations provided, nor have they verified it, except where they have explicitly so stated.

Further, the particular features of the scope of the work performed by KPMG, the contents of their report, and the level of details reflected in the report were determined by the purposes of the engagement and the needs of the directors of the Bank at the time the review was commissioned. Accordingly, the report and/or any extracts or parts thereof should not be regarded as suitable for use by any other persons or for any other purpose. KPMG accept no responsibility or liability in respect of the report or any extracts or parts thereof or references made with respect thereto to persons other than the Bank.

The report relates to certain matters as at 31 May 2003. Events may occur or may have occurred since that date and or since the date of the report, which, had they come to light prior to the date of the report, may have affected the conclusions reached or information contained in the report or any extracts thereof.

The rest of this appendix comprises a summary of the report by KPMG.

Appendix 4 *(continued)*

Summary of the Findings of KPMG *(continued)*

"High Level Controls Exercised by the Board

Board and Committee Structure

The Bank's existing corporate governance and high level control framework was substantially established at the time of the merger in October 2001. In essence, the Board structure follows a supervisory model in which all members are non-Executive except for the Chief Executive. As is common practice, Board committees have been established for the key supporting functions of Risk, Audit and Remuneration.

Since their establishment, the Board and the Board Committees have devoted substantial time to their responsibilities. For example, meetings of the Board have taken up to a full day, in order to consider substantial volumes of information and approve detailed policies and procedures in relation to risk management and other key areas.

While in many ways this approach of the Board has served the organisation well to date, the Bank may now be in a good position to re-assess the Board's role and the operation and responsibilities of Board level committees. This is also recognised by the Board members.

The fundamental purpose of such a re-assessment is to increase the effectiveness of the Board, and the efficiency with which it operates, and to increase the clarity of responsibility of management in relation to the running of the business. Our key recommendations for management to consider in this re-assessment include:

- The Bank to adopt a tiered approach whereby the Board considers only the most significant strategic and supervisory matters leaving the Board committees to deal with detailed policy approval and a more regular oversight of risk, financial and operational performance. Consideration should also be given to appointing more executive directors.

- The roles, responsibilities, composition and meeting frequency of the Board committees to be reviewed and standing agendas implemented to ensure that individually and collectively, these committees support the Board in discharging its ultimate oversight responsibility. The Bank to consider establishing an Executive Committee and a Nomination Committee. The Executive Committee would be able to discharge many of the currently more detailed responsibilities of the Board. The composition and responsibilities of the Executive Committee would need careful consideration by the Bank to realise the full potential of such a structure. Its establishment should provide the opportunity for greater levels of communication between management and the Board, and closer oversight of management's performance in executing strategy and managing the Bank's risk. The Chief Executive and his senior management team will continue to run the Bank acting through the Management Committee and other senior management forums.

- Information needs of the Board and the Board committees need to be examined to ensure that appropriate management information is provided to each body reflecting its roles and responsibilities. Standing information packs should present appropriate analysis of information and reporting against agreed key performance indicators. More use of exception reporting should be adopted, particularly for reporting to the Board.

Appendix 4 *(continued)*

Summary of the Findings of KPMG *(continued)*

"High Level Controls Exercised by the Board *(continued)*

Other High Level Controls

We also considered, at a high level, the key areas of strategy, planning and budgeting, risk management, management information and internal audit.

In relation to strategy, planning and budgeting, the Bank has set up an ambitious project to consider its Vision, Mission and Values. This is intended to set the context for the Bank's long term development plans. This project will need to integrate with the Bank's current strategic planning and budgeting process so that implementation of the vision can be facilitated.

In addition, the project's conclusions are likely to require significant changes in the management processes, and motivation, assessment and compensation schemes to align personal behaviors with the Bank's goals. The recruitment of skilled managers from outside the Bank is likely to be needed (these individuals can be highly effective as "change agents"). A shift in relative focus from business volume growth to quality of business is also required. Finance and risk functions will probably need to be given a greater profile and authority in the organisation, and the Bank will need to foster closer and more effective working relationships between finance and risk professionals and the front office.

It is widely recognised within the Bank that the achievement of these ambitious goals rests on the effective implementation of a number of key, and interlinking, IT projects. Each of these projects is highly significant in its own right, but in combination they represent a formidable challenge.

We have recommended a number of steps to achieve better governance of these projects and increase the likelihood of their success. The most significant of these steps is to establish a Programme Management Office to monitor and control the progress of each project and to manage their interaction more effectively. Part of the function of a Programme Management Office would be to take stock, at an early stage, of the achievability of current project goals and change the prioritisation, and perhaps, the whole approach to certain projects. It may be more appropriate to break down some projects into smaller, more readily achievable parts and adopt a "building block" approach to overall implementation.

We have suggested enhancements to Internal Audit's reporting to prioritise its recommendations and agree corrective action. We have also suggested the establishment of a tracking system for Internal Audit's recommendations which should provide greater assurance that actions agreed by management are implemented within agreed timeframes.

Appendix 4 *(continued)*

Summary of the Findings of KPMG *(continued)*

Credit Risk Management Framework

Proactive Credit Risk Management

The risk management framework established at the time of the merger sets out responsibilities for credit risk identification, measurement, monitoring and reporting. It also specifies the roles of the front and back offices including the independent Risk Management Department.

As the Bank strives to develop and embed improved risk management practices, we recommend that the importance of a proactive approach to credit risk management be emphasised. This will help develop a stronger working relationship between the risk and business functions and create an environment that encourages and rewards early identification of risk issues by all levels of staff in both front and back office. Liaison between the front office, Risk Management Department and Special Asset Management Department should be encouraged to maximise the Bank's recovery of potential problem loans. Development of a "watchlist" could assist in the early identification and resolution of such loans.

The desirability of such a relationship is clearly recognised by senior management in the relevant functions of the Bank, but its operation in day-to-day working practice needs to be more effective. A range of solutions is required: risk professionals need to be given greater profile and authority in the organisation, and culturally the front office will increasingly need to accept the positive role that effective risk management can play in developing profitable business. The Chief Risk Officer position also needs to be reassessed with a view to increasing its status in the organisation to rank alongside the business heads. This will help to ensure that the concerns of both the Chief Risk Officer and Risk Management Department are appropriately addressed in the credit decision making process.

Quality of Credit Analysis and the Credit Approval Framework

We are encouraged to see that the Bank is sponsoring a number of training initiatives aimed at improving the credit analysis capabilities of both front line and risk management staff. Our file review has highlighted that the existing credit analysis is highly variable and should be improved through: concurrent evaluation of the underlying business viability of the borrower and its group; a more rigorous analysis of cashflows and projections; use of more up to date financial information, and a more thorough and objective assessment of guarantors.

We have recommended that the Bank considers selective recruitment of credit risk management experts from a range of international best practice banks to enhance risk management processes and further develop the risk management culture.

The Bank's credit approval framework is clearly laid out in a delegated authority framework that requires independent credit approval by the Risk Management Department with escalation of larger customer exposures to more senior and experienced staff, the Chief Risk Officer and finally the Credit Committee. The risk function provides challenge to the front line with input into the transaction structuring process and recommendations for improving the Bank's risk position. Again, this framework needs to be further embedded within the day-to-day operations of the Bank. For example, our file review has indicated that concerns and comments raised by Risk Management Department during the credit analysis and approval process should be more clearly articulated and a more disciplined approach should be adopted in addressing these comments. We also note that the composition of the Credit Committee could be improved with an increase in independent representation. The Bank is addressing this issue with the proposed introduction of a Credit Risk Assessment Committee which has a higher proportion of members drawn from functions which are independent from the front office.

Appendix 4 *(continued)*

Summary of the Findings of KPMG *(continued)*

Credit Risk Management Framework *(continued)*

Performance Management

Remuneration structure for front office staff needs to encourage development of long term profitable business as opposed to short term volume and revenue growth. Remuneration structure of risk management and other back office staff should minimise dependency on performance of the front office and emphasise effective and efficient performance of risk management and other responsibilities. In 2003 the Bank started to establish the building blocks of a performance measurement framework with the aim of incorporating the above recommendations.

Risk Infrastructure

The need for accurate and complete credit risk data at customer and transaction levels is well recognised at all levels in the front and back offices. The Bank has initiated a number of important IT projects aimed at improving the accuracy and effectiveness of its credit risk measurement and management framework.

Enhancements to the risk reporting infrastructure should ensure that the Bank is able to provide a more granular analysis of the credit risk within each portfolio, the key risk drivers, and the underlying trends that need to be monitored. Revised reports should provide for increased consistency across the relevant functions, better use of risk migration analysis, analysis of group exposures, and more focused commentary on reported numerical information.

Whilst pursuing the relatively ambitious goals of the IT projects, the Bank should take steps to ensure that it does not lose sight of its more basic credit risk management requirements. These include the need for a platform to (i) provide accurate customer hierarchy, group and static data information, (ii) aggregate credit risk exposures at customer group level across product, business line, and legal entity in a timely fashion and (iii) better documentation of risk assessment and credit decisions.

Process and Control Framework

Since the merger, the Bank has devoted considerable resources to the establishment of an appropriate credit control framework. This is governed by a comprehensive set of credit risk management policies and procedures that continue to be refined as the regulatory requirements and business of the Bank evolve.

Our review has highlighted a number of areas where the implementation of policy and procedures could be enhanced. Our recommendations include:

- Expanding responsibilities for on-going customer monitoring to ensure that financials are obtained on a timely basis, deteriorations in creditworthiness are identified at an early stage and loan grades are adjusted accordingly

- Amending annual review procedures to increase the focus on group rather than borrower exposure

- Changing the delegated authority structure to ensure that adequate consideration is given to exposures to customers on a group basis

- Developing guidelines for setting and monitoring loan covenants

- Improving the temporary excess approval and monitoring framework

- Developing an enhanced approval and monitoring framework for syndicated loan facilities

Appendix 4 *(continued)*

Summary of the Findings of KPMG *(continued)*

Credit File Review

We have reviewed a portfolio of loans which was selected by the Bank based on criteria instructed by the Hong Kong Monetary Authority. This portfolio comprised 14% of the total Corporate Banking loan portfolio by value of gross exposure.

Based on our review, we have recommended that approximately 16% of the reviewed portfolio (by value of gross exposure) to be downgraded (mostly from Performing to Special Mention). We have also recommended additional specific provisions of HK$79 million. As the portfolio was selected based on a specific criteria, our conclusions may not necessarily be a representative of the portfolio as a whole. We have recommended that the Bank considers the result of our work in this light in arriving at the specific provision required for the whole portfolio. We have not recommended additional general provisions for loans that have been downgraded from Performing to Special Mention as we understand that this matter will be dealt with by the Bank in discussion with its external auditors.

We emphasise that the downgrades from Performing to Special Mention represent a significant portion of the portfolio examined by us. If these loans are not monitored carefully with a view to reducing the Bank's exposure, it is possible that a portion of these loans will deteriorate giving rise to a potentially significant amount of loss in the future.

While our review highlighted that the Bank generally operates in accordance with its policies for credit analysis, approval and monitoring, we have noted a number of areas where improvements should be made. Our key recommendations in this respect are set out under the "Credit risk management framework" above."

Appendix 5

List of Staff and External Parties Interviewed

Part A Staff

Name	Title	Department/Company
Cheung Kin Hung	Deputy Head of Division	Risk Management Department
Chin Lai Ngan	Deputy Head of Division	Bank-wide Operation Department
Chu Ka Wing	Former Deputy General Manager	Risk Management Department
Gao Zhibing	Deputy Head of Division	Risk Management Department
Ho Chu Hei	Officer	Risk Management Department
Hui Sze Wai	Manager	Chief Executive's Office
Kai Chi On	Deputy General Manager	Retail Banking Department
Kwok Chak Wah	Division Head	Corporate Banking & Financial Institutions Department
Lam Yim Nam	Deputy Chief Executive	Retail Banking Department
Lau Shuk Man	Manager	Bank-wide Operation Department
Law Man Wah	Chief Financial Officer	Finance Department
Lo Chung Hing	General Manager	Special Assets Management Department
Lo Tsui Har	Deputy Head of Division	Risk Management Department
Lok Kim Yuen	Senior Manager	Risk Management Department
Mao Xiaowei	Chief Risk Officer	Risk Management Department
Ng Rowena	Managing Director	BOCI Asia Limited
Or Man Ah	Deputy Chief Executive	Corporate Banking & Financial Institutions Department
Qiu Weidong	Senior Manager	Chief Executive's Office
Sun Jimmy	Manager	Corporate Banking & Financial Institutions Department
To Chi Wing	Deputy General Manager	Finance Department
Wang Wei Hung	General Manager	Legal & Compliance Department

Part B External Parties

External Parties	Capacity
KPMG	Section 59 Review Auditor
Moores Rowland	Section 59 Review Auditor
PricewaterhouseCoopers	Interim Results Auditor
Goldman Sachs	IPO Sponsor
UBS	IPO Sponsor
Bearing Point	CRS Project Consultant