THE HONG KONG ECONOMY

The Hong Kong economy steadily decelerated in 2001

As Hong Kong moved into 2001 there was considerable optimism coming on the back of the 10.5% growth in GDP during 2000. This optimism was misplaced as Hong Kong felt the impact of the burst technology bubble and the global economic slowdown, followed by the aftermath of the events of September 11 in the US. The economy steadily decelerated over the course of the year, with first quarter expansion of 2.2%, followed by growth of a mere 0.8% in the April to June period and contraction of 0.3% in the third quarter. The full year forecast is for contraction of as much as 2%.

Hong Kong's trade was the driving force in 2000, climbing 17%. This driver was missing in 2001. Total exports fell 5.8%, culminating in 10 consecutive months of decline. Domestic exports fell by a catastrophic 15.2%, and now comprise only 10.4% of total exports. The balance is represented by re-exports wherein Hong Kong adds little value to goods originating in China or destined for China. Imports fell by 5.4%, leaving Hong Kong with a visible trade deficit of US$87 billion. Indictors for 2002 are bleak with November orders on hand down 15%, the latest in 15 months of decline. The Hong Kong Purchasing Managers Index has also declined for 15 straight months.

Exports declined

The disappointing trade figures were mirrored by the 2% drop in container throughput, the first annual decline since this statistic was first gathered in 1989. Air cargo was down 7.4% to 2.07 million tons. Perhaps the only encouraging aspect of all the red numbers was the slowing rate of decline at the end of the year.

Property prices fell

Property is an important component of the local economy, but here again the news was depressing. A total of 88,200 transactions were recorded at the Land Registry, up 2.8%. But the positive aspect of this increase was offset by the fact that it is the second lowest increase in transaction volume in the past decade. The value of transactions fell 13% to HK$193 billion, the lowest figure in 11 years. Commercial rental values are down as much as 30%, and residential prices declined 9% on average over the course of the year, marginally better than the 15% decline for the year 2000.

Consumer spending down

Negative sentiment discouraged domestic consumption. The consumer price index fell 1.6% over the year, with December marking 38 successive months of price declines. Retail sales retreated by 0.8% in value over the first 11 months of the year, with negative figures for the July to November period. Many Hong Kong residents travel across the border to neighboring Shenzhen to take advantage of even lower prices, spending an estimated HK$19 billion shopping for daily necessities, clothes, dining and entertainment.

Unemployment climbed from 4.6% in December 2000 to 6.1% for the quarter ending December 2001. This sharp rise threatens to exceed the previous peak of 6.4% reached in January 1999 at the depth of the Asian financial crisis.

Hang Seng Index lost 25.5% in value

The stock market was not immune from the fallout of international events and cautious sentiment. The Hang Seng Index lost 25.5% in value over the year, one of the worst performances among global markets, ending the year at 11,397. The year low was reached on September 21 with the index down 41% from the year-end 2000 figure. 27 of the 33 Hang Seng Index constituent companies lost value during the year, most suffering losses of almost 20%. The Growth Enterprise Market, comprised of smaller and supposedly more high tech companies, fell 36%. Market capitalization fell to US$445 billion, making Hong Kong the ninth ranking market in the world. 88 IPOs in 2001 raised HK$25.4 billion in funds, while rights issues and other placements raised an additional HK$23 billion. Turnover was down by 33%.

Surprisingly, tourism rebounded in the last quarter of the year to produce a record 13.7 million arrivals, up 5.1% on 2000. Of the total, 4.4 million tourists came from China, an increase of 17.5% and an indication of the growing affluence of Chinese citizens. Passenger arrivals at Chek Lap Kok International Airport were down 0.9% to 33.1 million, with a late year surge preventing a serious decline.

The outlook for 2002 is rather bleak. Growth is projected to be flat to plus 2%, but Bank of China warns there could be further contraction in the first half of the year before Hong Kong rebounds. Much depends on the course of the US economy and its appetite for imports.

Budget deficit raises concern

The poor economic conditions have thrown down a challenge to the Hong Kong Government. After years of healthy budget surpluses, Hong Kong faces the prospect of a deficit that could be as high as HK$60 billion. Indeed, the Government did report a deficit of HK$61 billion for the nine months ending 31 December. The Treasury receives the overwhelming percentage of its tax revenues in the last 3 months of the fiscal year, which could reduce the deficit. However, it is almost certain that the size of the deficit will be a record, and it will be the 4th such deficit in the past 7 years.

This has touched off a debate over whether this is a cyclical or structural problem. Hong Kong has a narrow revenue base. Profits and salary tax have averaged 30-40% of government revenues in the past decade. There has been heavy reliance on the sale of land use rights and the proceeds from the privatization of companies such as the Mass Transit Railway Corporation. In the meantime expenditure has grown. There has been talk of introducing a sales tax to increase revenues, but no decisions have been announced. It does not seem appropriate to speak of new taxes when a high priority has to be placed on re-igniting consumer spending.

THE CHINESE ECONOMY

The lead story for the PRC in 2001 was the long awaited accession to the World Trade Organization. This signifies both the growing importance of China in international markets and the maturing of economic reforms. WTO membership will open up Chinese markets to more trade and investment, although we can expect implementation to encounter some resistance from industries and localities that will suffer loss of market share as a result. It will pressure state owned enterprises to adopt commercial practices in order to survive, and this was a major incentive for economic reformers to support the requirements for entry.

China GDP up 7.3%

The Chinese economy grew 7.3% in 2001 to reach US$1.15 trillion. The pace of growth gradually diminished over the course of the year, with quarterly growth of 8.1%, 7.8%, 7.0% and 6.5%, respectively. Exports rose 6.8% to US$268 billion compared to 27.8% growth in 2000. China was also a favored destination for foreign direct investment, attracting US$46.8 billion in funds, an increase of 15% over 2000. Contracted foreign investment, which gives an indication of future trends, was up 10% to US$64 billion. There are now 390,000 foreign invested companies in China producing 50% of total exports. The combination of a solid trade surplus and inward investment raised foreign reserves to US$212 billion, up a massive US$46.6 billion over December 2000.

THE HONG KONG BANKING INDUSTRY

Hang Seng Finance Index

Hong Kong banks were heavily affected by the economic retreat of 2001. Total loans fell by 11.2%, while loans for domestic use declined by 4.3%. Trade finance plummeted by 21%, while housing loans, the mainstay of many Hong Kong banks, only increased 0.4% against the very soft property market. These figures contrast to total loan contraction of 1.25% in 2000, while loans for domestic use grew 1.7%, trade finance declined by 8.6% and housing loans in 2000 increased by 0.7%.

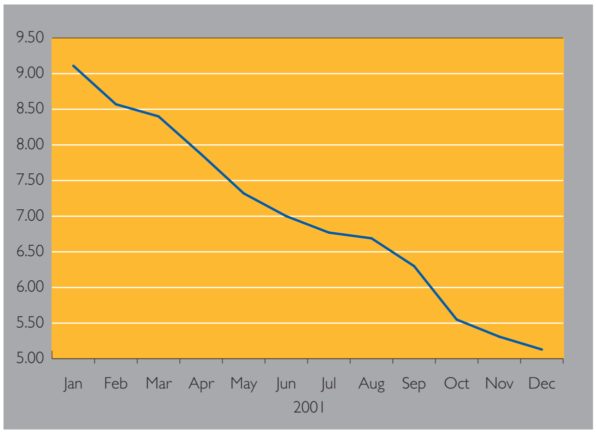
Loan demand retreated

Total bank deposits decreased by 3.6% between December 2000 and December 2001 as interest rates paid fell sharply. The lack of loan demand, resulting in high liquidity, and the repeated cuts in Federal Reserve rates, which largely determine rates in Hong Kong due to the link between the US dollar and the Hong Kong dollar, reduced the savings rate to 0.125%, one month HIBOR to 1.83% and the Prime rate to 5.125% in December 2001, the lowest rates in years.

Interest margins narrowed

Competition intensified in this dreary environment. Standard pricing for newly booked housing loans descended to Prime minus 2.5%, equivalent to 2.625% in December. This also encouraged existing mortgage holders to seek refinancing at these very favorable rates, driving down the yields on residential finance. Corporate borrowers were also able to raise funds at very attractive rates, and refinanced loans with a reduction of 100 basis points or more.

Hong Kong Dollar Prime Rate (Average Monthly Rate) (%)



Deregulation of interest rates

The lifting of the final restrictions on interest rates in July spelled the end of an era in Hong Kong. From the mid-1960s to the mid-1990s all deposits of HK$500,000 or less and with a tenor of 3 months or less fell under the purview of the Hong Kong Association of Banks, which set rates on a weekly basis. The restrictions on interest rates based on size and tenor were gradually liberalized over the past 7 years. It is perhaps fortunate that the final stage occurred at a time of high liquidity, thus avoiding a situation of keen competition for funds, which might have driven rates upwards. While some observers held that the interest rate regulations protected smaller banks, this segment welcomed the end of restrictions, convinced that a level playing field would allow their institutions to attract deposits on the basis of product features and service quality. New products were introduced, such as IBA's Magic Money Manager account, providing customers with an interest bearing current account, attracting new customers.

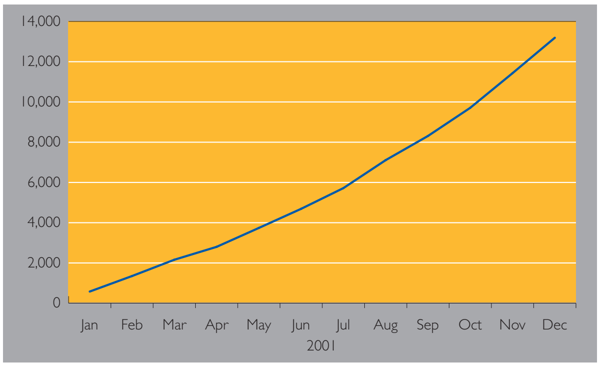
Deregulation also took the form of the ending of restrictions on the number of branches foreign banks are permitted to open. Between 1964 and 1978 no new branch licences were issued to foreign banks, and thereafter only single branch licences were issued. This anachronism has now been removed. More recently, the HKMA has removed the US$16 billion asset size criterion for issuance of branch licences to overseas-incorporated banks, substituting the same HK$5 billion total asset and HK$4 billion customer deposit criteria which is applied to locally incorporated banks.

Bank consolidation

There were some significant changes in ownership following Bank of East Asia's acquisition of First Pacific Bank in late 2000. In April Development Bank of Singapore surprised the market by acquiring Dao Heng Bank from the Hong Leong Group for a price of 3.3 times book, totaling HK$45 billion. At the end of 2001 CITIC Ka Wah Bank agreed to purchase Hongkong Chinese Bank from Lippo and China Resources for a total of HK$4.2 billion, equal to 1.4 times book. It is unclear if these transactions are a harbinger of further acquisitions.

Capital adequacy of Hong Kong banks remains high, and overall credit quality remains sound. The slowdown in the economy and the stagnating of loan growth has had obvious effects on profitability, with average increase in profits for the first half of 2001 slowing to 7% vs. 40% for the full year 2000. In addition to pressure on interest margins, other operating income has been affected by the downturn in the stock market, reducing commissions, lower trade finance and loan fees, and soft consumer spending which has limited the growth of credit card fees.

Cumulative Bankruptcy Petitions Received 2001



A new phenomenon has been the surge in personal bankruptcies. In 1999 the courts granted 3,071 personal bankruptcy orders. In 2001 this number rose to 13,186. The overwhelming majority of these are voluntary petitions. One major factor in the increase has been the change in bankruptcy legislation that permits the individual to come out of bankruptcy in four years instead of seven, with no responsibility for the previous debts. In this harsh economic environment some individuals have truly exhausted all their resources and seek genuine relief. The fall in property values has resulted in more than 60,000 families losing the equity in their homes, and some of these families have given up hope of recovery, leading to bankruptcy filings.

Rise in personal bankruptcies

A task force comprised of bank representatives, members of the Official Receiver's Office, the HKMA and consumer advocates, as well as the Office of the Privacy Commissioner, have been discussing ways of assisting genuinely distressed borrowers to restructure their debt. One missing element is a credit agency which would permit banks to exchange positive information on applicants, enabling them to identify individuals who are overstretching their repayment capabilities by taking on too high a level of credit. A solution may be found in 2002.

Strong financial system

The Hong Kong economy is changing, and the intermediation role played by local banks must adjust to these new conditions. A deposit insurance program, long overdue in Hong Kong, is expected to be in force by 2003. With a capable regulator in the form of the HKMA, solid capital bases, and sound experience, Hong Kong bankers will address the issues and the financial system will continue to enjoy stability.

IBA ACTIVITIES

This was not an auspicious environment for banks, which faced stagnant loan demand and increasing competition. Maintaining its focus on a well-defined retail banking strategy, IBA achieved solid results in 2001, reporting a 21% increase to HK$295 million in profit attributable to shareholders on the back of a strong net interest margin of 2.89%, one of the highest among Hong Kong banks. Return on assets rose to 1.04%, and return on equity stood at 8.45%. Total assets at year-end 2001 were HK$28.6 billion, with shareholder funds of HK$3.7 billion, rising 5.1% over December 2000. The Board of Directors has recommended a final dividend of 7 cents per share, up 40% from 5 cents in 2001, giving a full year dividend of 11 cents, compared to 8 cents in 2000, an increase of 38%.

Tsuen Wan Superbranch

Strong net interest margin

Growth in consumer loans

Increase in low cost deposits

The strong performance in net interest margins was driven by a combination of shifting to higher yielding loans and lower cost of funds, both the result of our sustained efforts to mold a balance sheet appropriate to new conditions in the banking sector. The range of consumer finance products was expanded, and the new Magic Money Manager Account, which combines the flexibility of a current account with the interest earning benefits of a savings account, was introduced in July after the removal of the last limitations on interest rates. Despite heavy pressure on interest margins as a result of stagnant loan growth, IBA preserved profitability as consumer loans increased form 4.7% to 6.3% of the loan portfolio, and low cost deposits increased by more than HK$1 billion in the second half of 2001.

Net interest income rose by 10.6% to HK$758 million. Other operating income of HK$142 million contributed to the 6% in increase in operating income to HK$900 million. Operating expenses of HK$487 million rose as a result of advertising and the promotion of new products, the opening of new business offices and depreciation of equipment and technology. IBA's investment in new businesses has already generated solid returns, producing two dollars of revenue for every dollar of investment.

After four years of economic difficulty, and with the timing of recovery uncertain, IBA took the initiative to increase general reserves for possible loan losses to one percent of total loans. Total charge for 2001 increased to HK$238 million comprised of general provisions of HK$63 million and specific provisions of HK$175 million.

Securities gains

Through active portfolio management over the course of the year, IBA restructured the investment portfolio to crystallize gains and position the portfolio for the rise of interest rates expected in 2002. This produced HK$132 in earnings compared to HK$44 million in 2000. Taxation of HK$12 million was reduced by HK$19 million due to tax credits.

High liquidity

The balance sheet was marked by high liquidity, with placements to banks of HK$5.9 billion and the securities portfolio of HK$3.4 billion. Total loans of 16.4 billion were down 6% year-on-year compared to a 11.2% decline in the banking system as a whole. There was a noticeable shift to consumer loans as IBA avoided increasing its lending in segments where yields were declining, helping to preserve the net interest margin. IBA's long-standing record of diversity was reinforced during 2001 through this selective lending policy. Loan quality also improved, with non-performing loans falling by 28% to HK$838 million, continuing a trend that began in 1999. Collateral and provisions provide 82.8% coverage of these loans. Over the course of the year IBA received substantial repayments against overdue PRC loans, with recoveries higher than previous provisions. Total assets as of 31 December 2001 were HK$28.6 billion, marginally lower than the previous year's figure of HK$29.2 billion.

Improved loan quality

Total deposits eased by 3%, managed in concert with the fall in loan demand. Liquidity remained high, averaging 44% over the year. Customer deposits totaled HK$22.2 billion and floating rate certificates of deposit, providing medium term funding of HK$1.6 billion. The introduction of the Magic Money Manager account enabled IBA to reduce interest expense more rapidly than the overall decline in interest rates, while attracting large numbers of new customers. The certificate of deposit total was increased by the HK$800 million issue completed in May 2001. IBA's loan to deposit ratio at the end of 2001 was a conservative 69%.

Mei Foo Wealth Management Center

IBA continued to expand its business network during the past 12 months. Five Superbranches, which provide more spacious premises and a wider range of services, now operate in Wanchai, Causeway Bay, Hunghom, Mei Foo and Tsuen Wan. Wealth Management Centers, which provide access to a wide range of investment opportunities, have been expanded to 6 locations. Consumer Finance Centers, providing prompt response to individuals seeking personal finance, are located in 4 popular locations. The bank's wholly owned hire purchase and leasing subsidiary, IBA Credit, moved its headquarters to newly purchased space in Central, reflecting strong growth in this business segment. IBA also upgraded its internet banking services through Net Alliance, emphasizing security and user-friendly procedures.

New investment products

IBA also maintained its leading role in Credit Card operations, adding benefits to its popular myCard and magiccard programs. Cardholders have access to special internet pages providing health advice and high tech games. IBA's Ambassador Privileged Banking continued to make inroads in personalized banking. Armed with new investment products and increased Treasury capabilities, this team of well-trained advisors delivers financial advice and services right to the door of their clients.

Emphasis on corporate governance

As a firm believer in sound corporate governance, IBA has strengthened its transparency and access to the public. In addition to the active participation of independent non-executive directors and the special role of the Regional Advisory Council comprised of community leaders who work with each branch manager, IBA has reinforced auditing and compliance with a more formal structure, and is the first bank to appoint a Corporate Governance Officer. IBA's efforts in this area have been recognized in CL Securities corporate governance survey which ranked IBA among the leading companies in Hong Kong.

IBA provides a wide range of financial services through its network of 34 outlets, including branches in Hong Kong, Kowloon and the New Territories, Wealth Management Centers in Mongkok, Yuen Long, Shatin, Causeway Bay, Mei Foo and Tsuen Wan, four Consumer Finance Centers in Central, Causeway Bay, Mongkok and Tsuen Wan, in addition to offsite ATMs and 24 Hour Electronic Banking Centers, and expanded phone banking service. Services include multi-currency deposits, personal loans, credit card issuance and merchant service, trade finance, residential mortgages, working capital loans, consumer hire-purchase and equipment leasing, stock brokerage and unit trust investments. IBA is listed on The Stock Exchange of Hong Kong, and is rated A-3 short-term, BBB long-term by Standard & Poor's.

Chek Lap Kok International Airport ATM

With the rapid changes in the Hong Kong banking industry and the volatile economic conditions, as well as the increasing importance of corporate governance, we have taken the opportunity to provide a much more detailed description of IBA's operations in this year's annual report. We hope this will give investors, clients and financial institutions a more thorough understanding of the bank.

Mike M. Murad

Vice Chairman, Managing Director and Chief Executive Officer

7 February 2002