

# REPORT OF CHIEF EXECUTIVE OFFICER

## MANAGEMENT DISCUSSION AND ANALYSIS

### 1. Review of Operations

In 2001, Hong Kong's economy continued to experience difficulties. In the face of such unfavourable operating circumstances, the Bank adopted the guiding principles of 'innovation, restructuring, and further growth'. As a result, we succeeded in achieving our major business targets, enlarging our asset base and achieving another year of record profits.

### 2. Business Performance

#### a. Earnings reached historic high levels

To overcome the challenges of a difficult operating environment, the Bank exercised stringent cost controls and focused on enhancing profitability by developing new value-added products and services and by increasing operational efficiency. As a result, profits hit record high levels.

In 2001, the Bank's operating profit before provisions amounted to HK\$1.03 billion, representing an increase of HK\$78 million, or 8.2%, over HK\$952 million in 2000. Profit attributable to shareholders was HK\$617 million, an increase of HK\$85 million, or 16%, over the HK\$532 million recorded in 2000. The Bank had a second consecutive year of record earnings.

#### b. Significant improvement in asset quality

At 2001 year-end, the Bank's loans and advances, at HK\$32.8 billion, were basically at 2000's level. Deposits fell HK\$2.3 billion, or 4.7%, from 2000's HK\$48.7 billion to HK\$46.4 billion. The Bank's total assets reached HK\$59.4 billion as of 2001 year-end, representing an increase of HK\$2.8 billion, or 4.9%, over 2000's HK\$56.7 billion.

In 2001, the Bank heightened its efforts to further enhance asset quality. A review of the credit administrative workflow was performed and the entire credit approval process was re-engineered and streamlined with a view to improving the quality of the Bank's loan portfolio. At the same time, in order to support new business development, the Bank implemented new credit policies and procedures in various new business areas, such as credit cards and consumer loans. As a result, various asset quality indicators surpassed market standards, as demonstrated by the 0.6% mortgage delinquency rate and the 2.3% and zero charge-off rates for unsecured personal lending and hire purchase and leasing facilities, respectively.

The Bank continued to make improvement in regard to the problem loans issue. In 2001, the Bank resolved a total of HK\$844 million of problem loans through cash collection, asset-for-debt swaps and debt restructuring. The classified exposure at year-end, including sub-standard, doubtful and loss categories, was significantly reduced from HK\$2.1 billion recorded at 2000 year-end to HK\$1.8 billion, representing 5.5% of total loans as of 2001 year-end. The coverage ratio increased from 80% in 2000 to 84% in 2001, while the NPL ratio dropped to 4.5%, and is expected to further decline.

In 2001, the Bank launched three certificates of deposits ('CDs') issues, totaling HK\$2.1 billion. The longest tenor issued was that of five years CDs. In an effort to effectively manage its capital requirements, the Bank issued its inaugural ten-year subordinated debt issue of US\$300 million in July, which was well received by international investors. In January 2002, the Bank successfully raised HK\$726 million through a rights issue, thereby further enhanced its capital adequacy ratio and fueling future growth.

Due to its prudent approach in treasury management, the Bank's financial position was further enhanced in 2001. At year-end, the unadjusted capital adequacy ratio was 20.8%; the loans to deposits ratio was 70.7%; the loans to total assets ratio was 55.2%; the property-related loan ratio was 45.6%; and the average liquidity ratio was 51.2%.

At 2001 year-end, various asset quality indicators pointed to a significant improvement in the quality of the Bank's asset portfolio as a result of the further strengthening of credit review and monitoring procedures.

## Asset Quality Indicators

	2001	2000	1999
Top 20 Customers Exposure as a Percentage of Total Indebtedness	23.0%	25.7%	32.9%
Classified Exposure (sub-standard, doubtful and loss)	5.5%	6.3%	8.4%
NPL*	4.5%	4.8%	5.6%
Capital Adequacy	20.8%	17.1%	19.2%
Loans to Deposits	70.7%	67.4%	67.9%
Loans to Total Assets	55.2%	57.9%	58.1%
Average Liquidity	51.2%	42.1%	39.5%

\*as a percentage of advances to customers

### c. Business recorded steady growth, non-interest income rose significantly

In 2001, the Bank achieved a steady growth in interest income through a combination of loan asset reshuffling and the development of high yield products and services. The improvement in loan returns, coupled with stringent efforts in regard to funding cost control and the restructuring of the Bank's loans and deposits mix, resulted in a net interest income of HK\$1.2 billion, representing an increase of HK\$95 million, or 8%, over 2000's level. Non-interest income surged by HK\$95 million, or 21%, to HK\$543 million as compared to HK\$448 million recorded in 2000. The main impetus for the non-interest income growth was fees generated from the sale of personal wealth management products such as unit trusts, insurance and bonds, new corporate facilities, bills, as well as net gains on equity and forex investments. The Bank will focus on exploring additional non-interest income avenues in an effort to further increase the contribution of non-interest income towards operating income from the current level of 30%.

During the year, the Bank launched a series of new products and services. A personal wealth management service was introduced in April, while the Bank formed a strategic alliance with Sun Life Financial (Hong Kong) Limited in May to jointly launch Bancassurance, thereby broadening its core range of wealth management products. In addition, the Bank launched its first credit card, CITIC Ka Wah VISA, in November to diversify its businesses and to open up a significant source of interest and non-interest revenue. The new credit card business will enable the Bank to build and strengthen customer relationships,

providing bountiful opportunities for cross-selling and business alliances. Since its launch, the Bank has already issued over 60,000 credit cards. The number of credit card customers is expected to surpass 100,000 by the end of 2002.

### **New Products and Services Launched in 2001**

January	- No monthly fee pledge and HK\$100 cash rebate for new depositors
March	- 'Click2Trade Station' e-business service - 'SME Loan' - Second phase of 'i-banking' service
April	- Launch of personal wealth management service with the opening of the inaugural Wealth Management Center at Taikoo Place - 'More Money' cash card account - 'Bond Investment' service
May	- Formed a strategic alliance with Sun Life Financial (Hong Kong) Limited to launch Bancassurance - 4% fixed deposit rate campaign - 'Sun RetireFun' life insurance service
July	- 'Unit Trust Savings Plan' - 'Life Plus' life insurance service
August	- 'Personal Installment Loan' at HK\$1 interest charge - Jointly launched general insurance products with Eagle Star Insurance
September	- 'Phone Enrollment' service for insurance application
October	- 'Internet Cash Management' service - 4% fixed rate deposit and insurance bundle product
November	- The Bank's first credit card 'CITIC Ka Wah VISA' - 'Salaries Tax Loan'
December	- 'Company Tax Loan'

Over the past two years, the Bank has launched over 30 new products and services. Together with the completion of its extensive service platform, the Bank is well positioned for further business growth.

#### **d. Improved risk management capability**

In 2000, work began on replacing the Bank's core banking system with the intention of better handling the Bank's long-term business development needs. The conversion of the first phase of the core banking system took place in September 2001 and the implementation of the second phase was completed in January 2002. The successful overhaul of the core banking system enhanced the Bank's internal management capability and infrastructure, including its capabilities in financial management, research and analysis, and operational flow.

In order to further raise the standard of operational risk management, the Bank established a back-up IT center in Shatin. Business contingency plans are being continually updated to reflect current changes in the operating environment. The Bank also undertook periodic test simulations in order to assure business continuity in the event of external disruptions to the Bank's major operating systems.

To make further improvements in corporate governance, the Compliance Department was established in July. The Internal Control Committee, being set up in August, was mandated to review, evaluate and improve the effectiveness of the internal control environment within the Bank and to facilitate and re-align the process of developing and approving the Bank's policies and procedures. In 2001, the Bank issued a Compliance Manual and provided the necessary training to all staff members, which raised staff awareness of a risk management culture.

#### **e. Human resources development**

At the end of 2001, the total number of employees stood at 1,127. Management believes it is 'people' that make the difference and create success for an organization. Hence, to attract and retain people of talent and good performance, the Bank makes continuous efforts in benchmarking and improving the remuneration structure. A bonus scheme covering all employees was initiated at the beginning of the year with an objective of cultivating common goals amongst employees, stimulating functional and cross-functional teamwork, driving individual performance and results for the Bank. The scheme has linked bonus amounts in direct correlation to the Bank's profitability,

departmental performance and individual contribution. Total staff costs of the Bank in 2001 was HK\$458 million.

A Senior Executive Share Option Scheme is maintained by the Bank, under which eligible senior executives of the Group are granted share options for subscription of shares of the Bank. At the end of 2001, the number of shares outstanding under the Option Scheme was 30,266,928.

The Bank has also put emphasis on staff training and people development. A total of 331 classes were organized during the year, the curriculums covering a wide range of subjects such as product and computer knowledge, management, regulatory developments, marketing and servicing skills.

<b>Staff Force</b>	<b>2001</b>	<b>2000</b>
By distribution:		
Head Office	<b>706</b>	593
Branches	<b>289</b>	310
Subsidiaries	<b>76</b>	82
Overseas Offices	<b>56</b>	50
Total	<b>1,127</b>	1,035
2. By grade:		
Assistant Manager and Above	<b>499</b>	408
Below Assistant Manager	<b>628</b>	627
Total	<b>1,127</b>	1,035
3. Voluntary Turnover Rate	<b>20.5%</b>	26.9%

### **3. Progress of Integration with The Hongkong Chinese Bank, Limited**

In November 2001, the Bank announced the acquisition of The Hongkong Chinese Bank, Limited. The related transaction was completed on 17 January 2002. As a result of this acquisition, the Bank's asset base was increased to around HK\$79.6 billion, thereby becoming the fourth largest listed bank in Hong Kong. Total deposits and total loans were approximately HK\$62.7 billion and HK\$44.7 billion respectively.

Following the completion, the two banks will continue to operate as separate entities, but with a view to becoming fully integrated by the end of 2002. An Integration Committee, comprising management of both banks, was established to decide on integration-related issues. The Bank has invested

much advance work and planning in the integration in order to maximize the overall benefits for customers, employees and shareholders. During the transition process, the two banks will seek cooperation in all aspects of business undertakings, customer referrals and back-office operations. The resultant effect will be better products and services for customers; more opportunities for employees; higher efficiency and profitability for the Bank; and earnings accretion for shareholders.

#### **4. Future Strategies**

The Bank has successfully laid a solid business foundation as a result of the efforts made in the past few years. In order to leverage on the network and strengths of its parent company in Mainland China and to capitalize on the numerous opportunities arising from China's entry to the World Trade Organization ('WTO'), the Bank is currently formulating plans to re-organize its group structure.

##### **a. Re-organization of group structure**

The Bank is in the process of formulating its re-organization plan, under which the Bank's three main businesses, namely commercial banking, investment banking and assets management will be re-organized under a financial holdings company. The main purpose of the re-organization is to provide customers with a full range of financial services, to enhance the group's overall competitiveness as a result of further specialization of management, and ultimately to deliver better returns for shareholders.

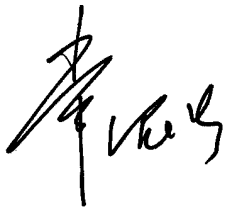
##### **b. Accelerate mainland market development**

The Bank signed a memorandum of understanding with CITIC Industrial Bank on 28 February 2002 with a view to establishing a long-term business co-operation relationship. The aims are to achieve a mutual sharing of complementary business strengths, the pooling of business resources, development of new business opportunities and the enhancement of risk management capabilities. The areas of co-operation will encompass priority participation in syndicated loans arranged by the other party; joint arrangement of foreign currencies and Renminbi dual-currency club deals; priority consideration given to the other party in the processing of international trade

settlements; and enhanced co-operation in product development in areas such as credit cards, personal financial management and personal loans.

## **5. Outlook**

Looking ahead, the Bank will continue to operate from its base in Hong Kong. With CITIC's support and the Bank's in-depth knowledge of the Hong Kong and Mainland markets, the Bank is well positioned to accelerate the development of its Mainland businesses and to capitalize on the vast opportunities that are arising as a result of China's entry to the WTO. The Bank will position itself as the provider of a full range of financial services and strive to become a premier financial group in Hong Kong, the Mainland and the region.

A handwritten signature in black ink, appearing to be 'Chang Zhenming', written in a cursive style.

**Chang Zhenming**  
*President and Chief Executive Officer*