



| Prudent Financial Management |

FINANCIAL REVIEW

Financial Performance

Profit and Loss Account

HK\$m	2002	2001
Operating profit before provisions	12,089	13,162
Operating profit after provisions	9,234	5,750
Profit before taxation	8,068	3,733
Profit attributable to shareholders	6,673	2,768
Earnings per share (HK\$ cents)	63.11	26.18
Return on average total assets	0.91%	0.36%
Return on average shareholders' funds	12.23%	7.31%

Attributable profit of the Group increased from HK\$2,768 million in 2001 to HK\$6,673 million in 2002. Operating profit before provisions decreased by HK\$1,073 million, or 8.2%, to HK\$12,089 million. Earnings per share of HK\$63.11 cents was 141.1% higher than in 2001. Return on average total assets increased by 0.55 percentage point to 0.91% while return on average shareholders' funds was 12.23%, an increase of 4.92 percentage points compared with 7.31% in 2001.

Net Interest Income

HK\$m	2002	2001
Net interest income	13,942	14,987
Average interest-earning assets	702,784	768,525
Net interest spread	1.85%	1.67%
Net interest margin	1.98%	1.95%

Net interest income fell by HK\$1,045 million, or 7.0%, to HK\$13,942 million.

Net interest spread improved by 18 basis points to 1.85%, but this effect on net interest income was offset by a reduction of 15 basis points in the contribution from net free funds, leading to a 3 basis points increase in net interest margin to 1.98%. The improvement in spread was the result of various asset and liability management initiatives including a significant reduction in inter-bank funding arrangements with BOC, increase in holding of debt securities, and cost savings through adjusting the pricing structure of deposits. Other factors contributing to the improvement of net interest spread were the increase in demand deposits, current accounts and savings deposits, and a reduction in the level of NPLs.

The improvement in general was partly offset by rate reductions on lending products due to increased competition in residential mortgages, subdued corporate loan demand, and the Group's strategy in adjusting the loan portfolio.

Other Operating Income

HK\$m	2002	2001
Other operating income	4,172	4,022
Net fees and commission income	2,948	2,696
Net gain from foreign exchange activities	824	816
Gross rental income from investment properties	279	257
Net (loss)/gain from other investments in securities	(61)	108

Other operating income increased by HK\$150 million, or 3.7%, to HK\$4,172 million, representing 23.03% of total operating income against 21.16% in 2001.

Net fees and commission income amounted to HK\$2,948 million, an increase of 9.3% compared with 2001. Key factors leading to the improvement included increase in wealth management income, increase in payment service fee income, strong growth in loan syndications, introduction of a levy on low-balance Hong Kong dollar savings accounts and a reduction in fees and commission expenses.

Increase in wealth management income was mainly due to commissions earned from sale of HK\$5.2 billion of investment funds. The increase in the number of credit cards issued and merchant acquiring business also contributed to the increase in net fees and commission income.

The improvement was offset by a 16.2% reduction in net commissions earned from stock brokerage owing to lower trading volumes in the market. Bills commission income also fell by 13.3% in 2002 but the trade finance business has shown signs of improvement in the second half of 2002.

The decrease in fees and commission expenses was mainly attributable to the reduction of cash rebates for residential mortgage loans charged to the profit and loss account due to a change in the amortisation method.

Net loss from other investments in securities consisted of HK\$145 million marked-to-market loss on debt securities as a result of a widening of the credit spread.

Operating Expenses

HK\$m	2002	2001
Operating expenses	6,025	5,847
Staff costs	3,578	3,796
Premises and equipment expenses excluding depreciation	803	892
Depreciation on owned fixed assets	632	460
Other operating expenses	994	676

Operating expenses increased by HK\$178 million, or 3.0%, to HK\$6,025 million.

Staff costs decreased by HK\$218 million, or 5.7%, to HK\$3,578 million due to a reduction in headcount as part of our rationalisation initiatives. As a result of the decrease in rental expenses and savings from consolidation of business operations, premises and equipment expenses decreased by HK\$89 million, or 10.0%, to HK\$803 million. Depreciation charges increased by HK\$172 million, or 37.4%, to HK\$632 million mainly due to the effect of recognising properties on the basis of market valuation at the time of the Restructuring and Merger. Increase in other operating expenses of HK\$318 million, or 47.0%, to HK\$994 million was due to write-offs of certain aged receivables, increase in professional fees, directors' and bank-wide indemnity insurance, and expenses relating to the expansion of credit card business. The cost to income ratio increased by 2.5 percentage points to 33.26% in 2002.

Charge for Bad and Doubtful Debts

HK\$m	2002	2001
Specific provisions		
– new provisions	4,519	10,649
– releases	(582)	(645)
– recoveries	(904)	(530)
	3,033	9,474
General provisions	(178)	(2,062)
Net charge for bad and doubtful debts	2,855	7,412

Net charge for bad and doubtful debts decreased by HK\$4,557 million, or 61.5%, to HK\$2,855 million. The net charge to average advances to customers fell from 2.2% in 2001 to 0.9% in 2002. New specific provisions decreased by HK\$6,130 million, or

57.6%, to HK\$4,519 million as a result of improved credit risk management, while more efficient debt collection and recovery process increased recoveries from HK\$530 million in 2001 to HK\$904 million in 2002.

Bad debt charge for credit card business increased by HK\$189 million, or 92.0%, to HK\$395 million, largely due to the high levels of personal bankruptcies experienced in Hong Kong. The charge-off ratio for credit cards was 12.33% for the year ended 31 December 2002.

Net Loss from Revaluation of Fixed Assets

In order to reflect the impact of the downward property value trends in Hong Kong since the previous revaluation performed in April 2002, all investment properties and certain premises were revalued by Chesterton Petty Limited, an independent valuer, at 31 December 2002. The revaluation of premises resulted in an increase in the Group's premises revaluation reserve by HK\$46 million and a charge to the profit and loss account by HK\$771 million in 2002. The revaluation of investment properties resulted in a loss that was first applied against in the Group's investment properties revaluation reserve of HK\$13 million and the remaining amount of HK\$206 million was charged to the profit and loss account in 2002.

Financial Position

Balance Sheet

HK\$m	2002	2001
Total assets	735,489	766,140
Inter-bank placements and short-term funds	178,526	254,877
Securities investments	190,232	145,586
Advances to customers	321,034	323,038
Fixed assets	20,212	21,049
Total liabilities	677,434	712,904
Deposits from customers	600,977	606,428
Certificates of deposit issued	–	5,000

Total assets decreased by HK\$30,651 million, or 4.0%, to HK\$735,489 million at 31 December 2002.

Inter-bank placements and short-term funds, decreased by HK\$76,351 million, or 30.0%, to HK\$178,526 million at 31 December 2002. After the Restructuring and Merger, BOCHK has, as a locally incorporated entity, developed a new set of liquidity management policies and mechanisms to address the Group's needs and the requirements of the HKMA. Consequently, inter-bank placement of HK\$54,635 million with BOC was withdrawn. Moreover, in accordance with our asset and liability management, inter-bank placements and short-term funds were reduced and redeployed into higher yielding debt securities.

Securities investments increased by HK\$44,646 million, or 30.7%, to HK\$190,232 million at 31 December 2002. Approximately 83% of the securities holdings were denominated in US dollar and Hong Kong dollar compared with 87% at 31 December 2001. Approximately 99% of securities holdings were investment grade securities rated by international recognised rating agencies.

Advances to customers decreased by HK\$2,004 million, or 0.6%, to HK\$321,034 million at 31 December 2002. On 26 June 2002, BOCHK disposed of loans with a gross book value of HK\$11,401 million net of specific provisions of HK\$2,679 million to BOC Cayman without recourse. Excluding the loan sale, advances to customers grew by HK\$9,437 million or 3.0%. This growth reflected the Group's efforts in increasing syndicated lending and residential mortgage lending. During the year, syndicated lending and residential mortgage loans grew by 5.5% and 4.0% respectively.

Outside Hong Kong and Mainland China, and after taking into account of transfer risk, advances to customers increased by HK\$7,322 million, or 169%, to HK\$11,654 million at 31 December 2002.

Fixed assets decreased by HK\$837 million, or 4.0%, to HK\$20,212 million at 31 December 2002. The fall was due to disposals of premises of HK\$572 million, deficits on revaluation of premises and investment properties of HK\$944 million and an increase in depreciation charges but was partly offset by acquisitions of premises and investment properties, totalling HK\$912 million. Large disposals of premises during the year included en-bloc properties such as China State Bank Building, Hua Chiao Commercial Bank Building and Yien Yieh Bank Building.

Total liabilities decreased by HK\$35,470 million, or 5.0%, to HK\$677,434 million at 31 December 2002. The decline was mainly due to the withdrawal of inter-bank fund of HK\$41,000 million by BOC.

Deposits from customers decreased by HK\$5,451 million, or 0.9%, to HK\$600,977 million at 31 December 2002. Demand deposits and current accounts grew by 15.2%, and savings accounts increased by 10.9%. This was offset by a 7.0% decline in time, call and notice deposits. This reflected customers' preference for liquidity in the low interest rate environment. During the year, the Group adjusted the pricing structure of deposits and put in place low-balance service charges. These measures were effective in controlling our funding costs.

As a result, the loans to deposits ratio increased by 0.15 percentage point to 53.42%.

Liquidity and Capital Management

HK\$m	2002	2001
Shareholders' funds	56,941	52,170
Capital adequacy ratio	13.99%	14.38%
Average liquidity ratio	41.17%	39.88%

Shareholders' funds increased by HK\$4,771 million, or 9.1%, to HK\$56,941 million at 31 December 2002.

The Group's consolidated capital adequacy ratio decreased by 0.39 percentage point to 13.99%. The capital base recorded a growth of 2.5% while risk-weighted assets rose by 5.3%. The increase in the capital base was a result of increase in retained profits, partly offset by the special dividend paid during the year. The increase in risk-weighted assets was mainly attributable to an increase in contingent liabilities and commitments.

The Group maintained a strong liquidity position, with the average liquidity ratio of 41.17%, compared with 39.88% in 2001.

Asset Quality

HK\$m	2002	2001
Non-performing loans	25,659	35,512
As a percentage to total loans	7.99%	10.99%
Specific provisions coverage ratio	33.66%	29.07%
Loan loss reserve ratio	58.51%	48.19%

During the year, the Group has achieved significant improvements in asset quality. NPLs decreased substantially by HK\$9,853 million, or 27.7%, to HK\$25,659 million at 31 December 2002. As a result, the ratio of NPLs to total loans reduced to 7.99% at 31 December 2002 from 10.99% at 31 December 2001. Classified loans to total loans also improved from 11.5% at 31 December 2001 to 8.0% at 31 December 2002.

The improvement was attributed to enhanced credit risk management that helped reduce new NPLs, more proactive recovery efforts in cash collection and collateral disposals, write-offs and the loan sale. During the year, the Group collected HK\$9,545 million of classified loans.

The Group has implemented a prudent and conservative policy in assessing the adequacy of provisions for bad and doubtful debts, in accordance with the guidelines set by the HKMA. During the year, the Group also increased the discount rates of collaterals such as industrial property, commercial property, land and shop to more conservative levels.

Specific provisions coverage ratio for NPLs improved from 29.07% to 33.66% at 31 December 2002 and loan loss reserve ratio improved from 48.19% to 58.51% at 31 December 2002. Specific provisions and collateral coverage for classified loans also increased from 85.62% to 90.08% at 31 December 2002.